NATIONAL CREDIT UNION ADMINISTRATION

RULES AND REGULATIONS

TRANSMITTAL SHEET **CHANGE 4**

NCUA 8006 (M3500) DATE: January 2003

TO: THE BOARD OF DIRECTORS OF THE FEDERAL CREDIT UNION OR THE FEDERALLY INSURED CREDIT UNION ADDRESSED:

This is Change 4 to the National Credit Union Administration Rules and Regulations (Revised November 2001)

1. **PURPOSE.** To update the National Credit Union Administration Rules and Regulations (Revised November 2001) in the following manner:

   a. **Part 702—Prompt Corrective Action**

   § 702.2—Definitions. Amended by redesignating current paragraphs (i) through (k) as new paragraphs (j) through (l). Added new paragraph (i) and revised newly designated paragraphs (k)(1)(i) and (k)(1)(iv). Removed the cross-reference to "paragraph (j)(1)" from newly designated paragraph (k)(2), and added cross-reference "paragraph (k)(1)."

   § 702.101—Measures and effective date of net worth classification. Amended by adding a heading to paragraph (b)(1); revised paragraph (b)(2); added a heading to paragraph (b)(3); and revised the heading of paragraph (c) and paragraph (c)(1).

   § 702.102—Statutory net worth categories. Revised Table 1 immediately preceding paragraph (b).

   § 702.103—Applicability of risk-based net worth requirement. Removed the heading "(a) Criteria" from paragraph (a); removed paragraph (b); and redesignated current paragraph (a) as the sectional introductory text, and paragraphs (a)(1) and (a)(2) as paragraphs (a) and (b), respectively.

   § 702.104—Risk portfolios defined. Removed the number "1" from the parenthetical "(Table 1)" in the introductory text and added in its place the number "2". Renumbered and redesignated other Tables throughout the part.

   § 702.105—Weighted-average life of investments. Removed the number "2" from the parenthetical "(Table 2)" in the introductory text and added the number "3". Removed the citation "§ 702.2(k)" in the introductory text and added the citation "§ 702.2(m)."

§ 702.107—Alternative components for standard calculation. Revised section (a) to the new Table 5 and added new section (d).

§ 702.108—Risk mitigation credit. Revised the section heading. Redesignated paragraphs (a) and (b) as paragraphs (b) and (c); added new paragraph (a); and revised newly designated paragraph (b).

Appendixes A-H to Subpart A of Part 702. Revised Appendix C. Redesignated Appendix F as Appendix H. Added new Appendices F and G. Revised newly designated Appendix H.

§ 702.201—Prompt corrective action for "adequately capitalized" credit unions. Revised.

§ 702.202—Prompt corrective action for "undercapitalized" credit unions. Removed the word "transfer" from the heading of paragraph (a)(1); added in its place the word "retention". Removed the words "or interest" from the heading and the text of paragraph (b)(3).

§ 702.203—Prompt corrective action for "significantly undercapitalized" credit unions. Removed the word "transfer" from paragraph (a)(1) and replaced with the word "retention". Removed the words "or interest" from the heading and the text of paragraph (b)(3).

§ 702.204—Prompt corrective action for "critically undercapitalized" credit unions. Revised the heading of paragraph (a)(1). Revised paragraph (b)(3) by removing the words "or interest" from the heading and the text. Revised paragraphs (c)(1)(iii) and (c)(4). Added new paragraph (d).

§ 702.205—Consultation with State officials on proposed prompt corrective action. Removed the words "place the credit union into conservatorship or liquidation" and added the words "take the proposed action". Removed from paragraph (c) the citation "702.201(b)".

§ 702.206—Net worth restoration plans. Revised paragraph (c)(1)(ii) and (c)(1)(iii). Added new paragraph (i).

§ 702.302—Net worth categories for new credit unions. Revised the table immediately preceding paragraph (d). Revised paragraph (d).

§ 702.303—Prompt corrective action for "adequately capitalized" new credit unions. Revised the introductory text.

§ 702.304—Prompt corrective action for "moderately capitalized," "marginally capitalized" or "minimally capitalized" new credit unions. Revised paragraphs (a)(1) through (a)(3).

§ 702.305—Prompt corrective action for "uncapitalized" new credit unions. Revised paragraphs (a), (c)(2) and added new paragraph (c)(3) and (d).

§ 702.306—Revised business plans for new credit unions. Revised paragraphs (a), (b)(2), and added new paragraph (h).

§ 702.401—Reserves. Revised paragraph (c).

§ 702.403—Payment of dividends. Revised paragraph (b).

b. **Part 703—Investment and Deposit Activities.**

§ 703.100—What investments and investment activities are permissible for me? Amended paragraph (c) by revising the second and third sentences and adding a fourth sentence.

c. **Part 704—Corporate Credit Unions.**

§ 704.2—Definitions. Revised by removing the definition of *"commercial mortgage related security", "correspondent services", "credit enhancement", "dealer bid indication", "expected maturity", "industry recognized information provider", "long term investment", "market price", "matched", "member paid-in capital", "mortgage servicing", "net interest income", "non member paid-in capital", "non secured obligation", "prepayment model", "real estate mortgage investment conduit (REMIC)", "reserve ratio", "reserves and undivided earnings", "short-term investment", and "trade association."*

§ 704.3—Corporate credit union capital. Revised paragraph (a). Redesignated paragraphs (d) through (g) as paragraphs (e) through (h); and paragraph (b) as paragraph (d). Removed paragraph (c); added paragraphs (b), (c), and (i). Revised redesignated paragraphs (e) heading, (e)(1) introductory text, (e)(2) and (e)(3)(iii) and (f). Removed the acronym "NCUA" and replaced with "the OCCU Director" in paragraphs (e)(3)(i) and (ii), (g)(2)(v) and (g)(3).

§ 704.4—Board responsibilities. Removed the word "operating" in paragraphs (a) and (b) and revised paragraph (c) introductory text.

§ 704.5—Investments. Revised paragraphs (a)(1) and (2); (c)(5), (d)(1), (e)(1), (3) and (4), (f), and (h)(2) and (3). Removed paragraphs (c)(6), (d)(3) and (d)(6). Redesignated paragraphs (d)(4) and (d)(5) as paragraphs (d)(3) and (d)(4). Revised redesignated paragraphs (d)(3) and the first sentence of (d)(4); added paragraph (h)(4); and added a semicolon after the word "and" in paragraph (c)(4).

§ 704.6—Credit risk management. Revised introductory text in paragraph (a); and revised paragraphs (a)(3), (a)(4), and (b) through (e).

§ 704.7—Lending. Removed paragraphs (c) through (g); added paragraphs (c) through (f) and redesignated paragraph (h) as paragraph (g).

§ 704.8—Asset and liability management. Removed paragraphs (a)(2), (a)(5) and (e); redesignated paragraphs (a)(3) and (a)(4) as (a)(2) and (a)(3), (a)(6) and (a)(7) as (a)(4) and (a)(5), and (f) and (g) as (e) and (f). Added "; and" at the end of redesignated paragraph (a)(5) in place of the period. Added paragraph (b)(6); revised redesignated paragraphs (a)(2), (e) and (f). Added a sentence to the end of paragraph (c); and revised paragraphs (d)(1)(i) through (iii) and (d)(2) introductory text.

§ 704.10—Investment action plan. Revised the section heading and the first sentence of paragraph (a). Replaced the acronym "NCUA" with "the OCCU Director" in paragraphs (a), (b) and (c).

§ 704.11—Corporate Credit Union Service Organizations (Corporate CUSOs). Revised paragraph (b), redesignated paragraphs (c) through (e) as paragraphs (f) through (h), added paragraphs (c), (d), and (e) and revised redesignated paragraph (g)(3).

§ 704.12—Permissible services. Revised the heading and added new paragraphs (a) through (c).

§ 704.13—Fixed assets. Removed and Reserved.

§ 704.14—Representation. Revised introductory text of paragraph (a) and redesignating paragraphs (b) through (d) as (c) through (e). Added a new paragraph (b).

§ 704.15—Audit requirements. Replaced the acronym "NCUA" with "the OCCU Director" in paragraphs (a) and (b).

§ 704.18—Fidelity bond coverage. Amended paragraph (e)(1) by removing the words "reserve ratio" and replacing the words "core capital ratio" and removing the words "reserves and undivided" and replacing with the word "retained."

§ 704.19—Wholesale corporate credit unions. Revised paragraph (b) and removed paragraph (c).

Appendix A to Part 704—Model Forms. Revised.

Appendix B to Part 704—Expanded Authorities and Requirements. Revised.

d. **Part 722—Appraisals**

§ 722.3—Appraisals required; transactions requiring a State certified or licensed appraiser. Revised the number "50,000" in paragraph (b)(2) to read "250,000."

e. **Part 741—Requirements for Insurance.**

§ 741.3 Criteria. Removed the words "Adequacy of" from the heading of paragraph (a); removed paragraph (2) and redesignated current paragraph (a)(3) as paragraph (a)(2).

f. **Part 747—Administrative Actions, Adjudicative Hearings, Rules of Practice and Procedure, and Investigations.**

§ **747.2005—Enforcement of orders.** Revised paragraph (b)(2).

2. This change also reflects a correction to a typographical error found on page 701–14.

3. **INSTRUCTIONS.**

a. Your November 2001 NCUA Rules and Regulations should be updated as follows:

REMOVE OLD PAGES	INSERT NEW PAGES
i–xv	i–xv
701–13 thru 701–14	701–13 thru 701–14
702–1 thru 702–25	702–1 thru 702–26
703–3 thru 703–4	703–3 thru 703–6
704–1 thru 704–19	704–1 thru 704–20
722–3 thru 722–4	722–3 thru 722–4
741–1 thru 741–2	741–1 thru 741–2
747–39	747–39

4. **PREAMBLES.** Enclosed with Change 4 are the Federal Register published preambles. Although not part of the rules, you may find them useful for explanatory purposes.

TABLE OF CONTENTS

*THESE PARTS APPLY TO FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS AS WELL AS FEDERAL CREDIT UNIONS

TABLE OF CONTENTS

*THESE PARTS APPLY TO FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS AS WELL AS FEDERAL CREDIT UNIONS

TABLE OF CONTENTS

*THESE PARTS APPLY TO FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS AS WELL AS FEDERAL CREDIT UNIONS

TABLE OF CONTENTS

Section *Page*

*THESE PARTS APPLY TO FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS AS WELL AS FEDERAL CREDIT UNIONS

TABLE OF CONTENTS

*THESE PARTS APPLY TO FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS AS WELL AS FEDERAL CREDIT UNIONS

TABLE OF CONTENTS

Section *Page*

Part 713—Fidelity Bond and Insurance Coverage for Federal Credit Unions

Part 714—Leasing

Part 715—Supervisory Committee Audits and Verifications

Part 716—Privacy of Consumer Financial Information and Appendix *

Subpart A—Privacy and Opt Out Notices

Subpart B—Limits on Disclosures

* THESE PARTS APPLY TO FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS AS WELL AS FEDERAL CREDIT UNIONS

TABLE OF CONTENTS

Section *Page*

*THESE PARTS APPLY TO FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS AS WELL AS FEDERAL CREDIT UNIONS

TABLE OF CONTENTS

*THESE PARTS APPLY TO FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS AS WELL AS FEDERAL CREDIT UNIONS

TABLE OF CONTENTS

*THESE PARTS APPLY TO FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS AS WELL AS FEDERAL CREDIT UNIONS

TABLE OF CONTENTS

Section *Page*

Subpart A—Uniform Rules of Practice and Procedure

Subpart B—Local Rules of Practice and Procedure

Subpart C—Local Rules and Procedures Applicable to Proceedings for the Involuntary Termination of Insured Status

TABLE OF CONTENTS

Section *Page*

TABLE OF CONTENTS

*THESE PARTS APPLY TO FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS AS WELL AS FEDERAL CREDIT UNIONS

TABLE OF CONTENTS

Section *Page*

Part 790—Description of NCUA; Requests for Agency Action

Part 791—Rules of NCUA Board Procedure; Promulgation of NCUA Rules and Regulations; Public Observation of NCUA Board Meetings

Subpart A—Rules of NCUA Board Procedure

Subpart B—Promulgation of NCUA Rules and Regulations

Subpart C—Public Observation of NCUA Board Meetings Under the Sunshine Act

Part 792—Requests for Information Under the Freedom of Information Act and Privacy Act, and by Subpoena; Security Procedures for Classified Information

Subpart A—The Freedom of Information Act

TABLE OF CONTENTS

TABLE OF CONTENTS

Section *Page*

in the vicinity of the dwelling for which a real estate-related loan is requested.

(2) With regard to a real estate-related loan, a Federal credit union may not consider a lending criterion or exercise a lending policy which has the effect of discriminating on the basis of race, color, national origin, religion, sex, handicap, or familial status (having children under the age of 18). Guidelines concerning possible exceptions to this provision appear in paragraph (e)(1) of this section.

(3) Consideration of any of the following factors in connection with a real estate-related loan is not necessary to a Federal credit union's business, generally has a discriminatory effect, and is therefore prohibited:

(i) the age or location of the dwelling;

(ii) zip code of the applicant's current residence;

(iii) previous home ownership;

(iv) the age or location of dwellings in the neighborhood of the dwelling;

(v) the income level of residents in the neighborhood of the dwelling;

Guidelines concerning possible exceptions to this provision appear in paragraph (e)(2) of this section.

(c) *Nondiscrimination in Appraisals:*

(1) A Federal credit union may not rely upon an appraisal of a dwelling if it knows or should know that the appraisal is based upon consideration of the race, color, national origin, religion, sex, handicap, or familial status (having children under the age of 18) of:

(i) any applicant or joint applicant;

(ii) any person associated, in connection with a real estate-related loan application, with an applicant or joint applicant;

(iii) the present or prospective owners, lessees, tenants, or occupants of the dwelling for which a real estate-related loan is requested;

(iv) the present or prospective owners, lessees, tenants, or occupants of other dwellings in the vicinity of the dwelling for which a real estate-related loan is requested.

(2) With respect to a real estate-related loan, a Federal credit union may not rely upon an appraisal of a dwelling if it knows or should know that the appraisal is based upon consideration of a criterion which has the effect of discriminating on the basis of race, color, national origin, religion, sex, handicap, or familial status (having children under the age of 18). Guidelines concerning possible exceptions to this provision appear in paragraph (e)(1) of this section.

(3) A Federal credit union may not rely upon an appraisal that it knows or should know is based upon consideration of any of the following criteria, for such criteria generally have a discriminatory effect, and are not necessary to a Federal credit union's business:

(i) the age or location of the dwelling;

(ii) the age or location of dwellings in the neighborhood of the dwelling;

(iii) the income level of the residents in the neighborhood of the dwelling.

(4) Notwithstanding paragraph (c)(3) of this section, it is recognized that there may be factors concerning location of the dwelling which can be properly considered in an appraisal. If any such factor(s) is relied upon, it must be specifically documented in the appraisal, accompanied by a brief statement demonstrating the necessity of using such factor(s). Guidelines concerning the consideration of location factors appear in paragraph (e)(3) of this section.

(5) Each Federal credit union shall make available, to any requesting member/applicant, a copy of the appraisal used in connection with that member's real estate-related loan application. The appraisal shall be available for a period of 25 months after the applicant has received notice from the Federal credit union of the action taken by the Federal credit union on the real estate-related loan application.

(d) *Nondiscrimination in advertising.* No federal credit union may engage in any form of advertising of real estate-related loans that indicates the credit union discriminates on the basis of race, color, religion, national origin, sex, handicap, or familial status in violation of the Fair Housing Act. Advertisements must not contain any words, symbols, models or other forms of communication that suggest a discriminatory preference or policy of exclusion in violation of the Fair Housing Act or the Equal Credit Opportunity Act.

(1) *Advertising notice of nondiscrimination compliance.* Any federal credit union that advertises real estate-related loans must prominently indicate in such advertisement, in a manner appropriate to the advertising medium and format used, that the credit union makes such loans without regard to race, color, religion, national origin, sex, handicap, or familial status.

(i) With respect to written and visual advertisements, a credit union may satisfy the notice requirement by including in the advertisement a copy of the logotype, with the legend "Equal Hous-

ing Lender," from the poster described in paragraph (d)(3) of this section or a copy of the logotype, with the legend "Equal Housing Opportunity," from the poster described in § 110.25(a) of the United States Department of Housing and Urban Development's (HUD) regulations (24 CFR 110.25(a)).

(ii) With respect to oral advertisements, a credit union may satisfy the notice requirement by a spoken statement that the credit union is an "Equal Housing Lender" or an "Equal Opportunity Lender."

(iii) When an oral advertisement is used in conjunction with a written or visual advertisement, the use of either of the methods specified in paragraphs (d)(1)(i) or (ii) of this section will satisfy the notice requirement.

(iv) A credit union may use any other method reasonably calculated to satisfy the notice requirement.

(2) *Lobby notice of nondiscrimination.* Every federal credit union that engages in real estate-related lending must display a notice of nondiscrimination. The notice must be placed in the public lobby of the credit union and in the public area of each office where such loans are made and must be clearly visible to the general public. The notice must incorporate either a facsimile of the logotype and language appearing in paragraph (d)(3) of this section or the logotype and language appearing at 24 CFR 110.25(a). Posters containing the logotype and language appearing in paragraph (d)(3) of this section may be obtained from the regional offices of the National Credit Union Administration.

(3) *Logotype and notice of nondiscrimination compliance.* The logotype and text of the notice required in paragraph (d)(2) of this section shall be as follows:

EQUAL HOUSING
LENDER

We Do Business in Accordance With the Federal Fair Lending Laws

UNDER THE FEDERAL FAIR HOUSING ACT, IT IS ILLEGAL, ON THE BASIS OF RACE, COLOR, NATIONAL ORIGIN, RELIGION, SEX, HANDICAP, OR FAMILIAL STATUS (HAVING CHILDREN UNDER THE AGE OF 18), TO:

- Deny a loan for the purpose of purchasing, constructing, improving, repairing or maintaining a dwelling, or deny any loan secured by a dwelling; or
- Discriminate in fixing the amount, interest rate, duration, application procedures or other terms or conditions of such a loan, or in appraising property.

IF YOU BELIEVE YOU HAVE BEEN DISCRIMINATED AGAINST, YOU SHOULD SEND A COMPLAINT TO:

Assistant Secretary for Fair Housing and Equal Opportunity
Department of Housing & Urban Development
Washington, D.C. 20410
For processing under the Federal Fair Housing Act
and to:
National Credit Union Administration
Office of Examination and Insurance
1775 Duke Street
Alexandria, VA 22314–3428
For processing under NCUA Regulations

****

UNDER THE EQUAL CREDIT OPPORTUNITY ACT, IT IS ILLEGAL TO DISCRIMINATE IN ANY CREDIT TRANSACTION:

- On the basis of race, color, national origin, religion, sex, marital status, or age
- Because income is from public assistance, or
- Because a right was exercised under the Consumer Credit Protection Act.

IF YOU BELIEVE YOU HAVE BEEN DISCRIMINATED AGAINST, YOU SHOULD SEND A COMPLAINT TO:

National Credit Union Administration
Office of Examination and Insurance
1775 Duke Street
Alexandria, VA 22314–3428

(e) *Guidelines:*

(1) Compliance with the Fair Housing Act is achieved when each loan applicant's creditworthiness is evaluated on an individual basis, without presuming that the applicant has certain characteristics of a group. If certain lending policies or procedures do presume group characteristics, they may violate the Fair Housing Act, even though the characteristics are not based upon race, color, sex, national origin, religion, handicap, or familial status. Such a violation occurs when otherwise facially nondiscriminatory lending procedures (either general lending policies or specific criteria used in reviewing loan applications) have the effect of making real estate-related loans unavailable or less available on the basis of race, color, sex, national origin, religion, handicap, or familial status. Note, however, that a policy or criterion which has a discriminatory effect is not a violation of the Fair Housing Act if its use achieves a legitimate business necessity which cannot be achieved by using less discriminatory standards. It is also important to note that the Equal Credit Opportunity Act and Regulation B prohibit discrimination, either per se or in effect, on the basis of the applicant's age, marital status, receipt of public assistance, or the exer-

Part 702

Prompt Corrective Action

§ 702.1 Authority, purpose, scope and other supervisory authority.

(a) *Authority.* Subparts A, B and C of this part and subpart L of part 747 of this chapter are issued by the National Credit Union Administration pursuant to section 216 of the Federal Credit Union Act (FCUA), 12 U.S.C. 1790d (section 1790d), as added by section 301 of the Credit Union Membership Access Act, Pub. L. No. 105–219, 112 Stat. 913 (1998). Subpart D of this part is issued pursuant to FCUA section 120, 12 U.S.C. 1766.

(b) *Purpose.* The express purpose of prompt corrective action under section 1790d is to resolve the problems of federally-insured credit unions at the least possible long-term loss to the National Credit Union Share Insurance Fund. This part carries out the purpose of prompt corrective action by establishing a framework of mandatory and discretionary supervisory actions, applicable according to a credit union's net worth ratio, designed primarily to restore and improve the net worth of federally-insured credit unions.

(c) *Scope.* This part implements the provisions of section 1790d as they apply to federally-insured credit unions, whether federally- or state-chartered; to such credit unions defined as "new" pursuant to section 1790d(b)(2); and to such credit unions defined as "complex" pursuant to section 1790d(d). Certain of these provisions also apply to officers and directors of federally-insured credit unions. This part does not apply to corporate credit unions. Procedures for issuing, reviewing and enforcing orders and directives issued under this part are set forth in subpart L of part 747 of this chapter, 12 CFR 747.2001 *et seq.*

(d) *Other supervisory authority.* Neither § 1790d nor this part in any way limits the authority of the NCUA Board or appropriate State official under any other provision of law to take additional supervisory actions to address unsafe or unsound practices or conditions, or violations of applicable law or regulations. Action taken under this part may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the NCUA Board or appropriate State official, including issuance of cease and desist orders, orders of prohibition, suspension and removal, or assessment of civil money penalties, or any other actions authorized by law.

§ 702.2 Definitions

Except as provided below, the terms used in this part have the same meanings as set forth in FCUA sections 101 and 216, 12 U.S.C. 1752, 1790d.

(a) *Appropriate regional director* means the director of the NCUA regional office having jurisdiction over federally-insured credit unions in the state where the affected credit union is principally located.

(b) *Appropriate State official* means the commission, board or other supervisory authority having jurisdiction over credit unions chartered by the State which chartered the affected credit union.

(c) *Credit union* means a federally-insured, natural person credit union, whether federally- or State-chartered, as defined by 12 U.S.C. 1752(6).

(d) *CUSO* means a credit union service organization as described in 12 CFR 712 *et seq.* for federally-chartered credit unions, and as defined under State law for State-chartered credit unions.

(e) *NCUSIF* means the National Credit Union Share Insurance Fund as defined by 12 U.S.C. 1783.

(f) *Net worth* means the retained earnings balance of the credit union at quarter end as determined under generally accepted accounting principles. Retained earnings consists of undivided earnings, regular reserves, and any other appropriations designated by management or regulatory authorities. This means that only undivided earnings and appropriations of undivided earnings are included in net worth. For low income-designated credit unions, net worth also includes secondary capital accounts that are uninsured and subordinate to all other claims, including claims of creditors, shareholders and the NCUSIF. For

any credit union, net worth does not include the allowance for loan and lease losses account.

(g) *Net worth ratio* means the ratio of the net worth of the credit union (as defined in paragraph (f) of this section to the total assets of the credit union (as defined by a measure chosen under paragraph (j) of this section.

(h) *New credit union* means a federally-insured credit union which both has been in operation for less than ten (10) years and has $10,000,000 or less in total assets.

(i) *Senior executive officer* means a senior executive officer as defined by 12 CFR 701.14(b)(2).

(j) *Shares* means deposits, shares, share certificates, share drafts, or any other depository account authorized by federal or state law.

(k) *Total assets*

(1) Total assets means a credit union's total assets as measured by either—

(i) *Average quarterly balance.* The average of quarter-end balances of the current and three preceding calendar quarters; or

(ii) *Average monthly balance.* The average of month-end balances over the three calendar months of the calendar quarter; or

(iii) *Average daily balance.* The average daily balance over the calendar quarter; or

(iv) *Quarter-end balance.* The quarter-end balance of the calendar quarter as reported on the credit union's Call Report.

(2) For each quarter, a credit union must elect a measure of total assets from paragraph (k)(1) of this section to apply for all purposes under this part except §§ 702.103 through 702.108 [risk-based net worth requirement].

(l) *Weighted-average life* means the weighted-average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time), and then summing and dividing by the total amount of principal.

Subpart A—Net Worth Classification

§ 702.101 Measures and effective date of net worth classification

(a) *Net worth measures.* For purposes of this part, a credit union must determine its net worth category classification at the end of each calendar quarter using two measures:

(1) The net worth ratio as defined in § 702.2(g); and

(2) If determined to be applicable under § 702.103, a risk-based net worth requirement.

(b) *Effective date of net worth classification.* For purposes of this part, the effective date of a federally-insured credit union's net worth category classification shall be the most recent to occur of:

(1) *Quarter-end effective date.* The last day of the calendar month following the end of the calendar quarter; or

(2) *Corrected net worth category.* The date the credit union received subsequent written notice from NCUA or, if State-chartered, from the appropriate State official, of a decline in net worth category due to correction of an error or misstatement in the credit union's most recent Call Report; or

(3) *Reclassification to lower category.* The date the credit union received written notice from NCUA or, if State-chartered, the appropriate State official, of reclassification on safety and soundness grounds as provided under §§ 702.102(b) or 702.302(d).

(c) *Notice to NCUA by filing Call Report.* (1) Other than by filing a Call Report, a federally-insured credit union need not notify the NCUA Board of a change in its net worth ratio that places the credit union in a lower net worth category;

(2) Failure to timely file a Call Report as required under this section in no way alters the effective date of a change in net worth classification under this paragraph (b) of this section, or the affected credit union's corresponding legal obligations under this part.

§ 702.102 Statutory net worth categories.

(a) *Net worth categories.* Except for credit unions defined as "new" under subpart B of this part, a federally-insured credit union shall be classified (Table 1)—

(1) *Well capitalized* if it has a net worth ratio of seven percent (7%) or greater and also meets any applicable risk-based net worth requirement under §§ 702.103 through 702.108; or

(2) *Adequately capitalized* if it has a net worth ratio of six percent (6%) or more but less than seven percent (7%), and also meets any applicable risk-based net worth requirement under §§ 702.103 through 702.108 below; or

(3) *Undercapitalized* if it has a net worth ratio of four percent (4%) or more but less than six percent (6%), or fails to meet any applicable risk-based net worth requirement under §§ 702.103 through 702.108; or

(4) *Significantly undercapitalized* if it

(i) Has a net worth ratio of two percent (2%) or more but less than four percent (4%); or

(ii) Has a net worth ratio of four percent (4%) or more but less than five percent (5%), and either—

(A) Fails to submit an acceptable net worth restoration plan within the time prescribed in § 702.206; or

(B) Materially fails to implement a net worth restoration plan approved by the NCUA Board; or

(5) *Critically undercapitalized* if it has a net worth ratio of less than two percent (2%).

TABLE 1 – STATUTORY NET WORTH CATEGORY CLASSIFICATION

A credit union's net worth category is . . .	*if its net worth ratio is . . .*	*and subject to the following condition(s) . . .*
"Well Capitalized"	7% or above	Meets applicable risk-based net worth (RBNW) requirement
"Adequately Capitalized"	6% to 6.99%	Meets applicable RBNW requirement
"Undercapitalized"	4% to 5.99%	Or fails applicable RBNW requirement
"Significantly Undercapitalized"	2% to 3.99%	Or if "undercapitalized" at <5% net worth ratio and fails to timely submit or materially implement Net Worth Restoration Plan
"Critically Undercapitalized"	Less than 2%	None

(b) *Reclassification based on supervisory criteria other than net worth.* The NCUA Board may reclassify a "well capitalized" credit union as "adequately capitalized" and may require an "adequately capitalized" or "undercapitalized" credit union to comply with certain mandatory or discretionary supervisory actions as if it were in the next lower net worth category (each of such actions hereinafter referred to generally as "reclassification") in the following circumstances:

(1) *Unsafe or unsound condition.* The NCUA Board has determined, after notice and opportunity for hearing pursuant to § 747.2003 of this chapter, that the credit union is in an unsafe or unsound condition; or

(2) *Unsafe or unsound practice.* The NCUA Board has determined, after notice and opportunity for hearing pursuant to § 747.2003 of this chapter, that the credit union has not corrected a material unsafe or unsound practice of which it was, or should have been, aware.

(c) *Non-delegation.* The NCUA Board may not delegate its authority to reclassify a credit union under paragraph (b) of this section.

(d) *Consultation with State officials.* The NCUA Board shall consult and seek to work cooperatively with the appropriate State official before reclassifying a federally-insured State-chartered credit union under paragraph (b) of this section, and shall promptly notify the appropriate State official of its decision to reclassify.

§ 702.103 Applicability of risk-based net worth requirement.

For purposes of § 702.102, a credit union is defined as "complex" and a risk-based net worth requirement is applicable only if the credit union meets both of the following criteria as reflected its most recent Call Report:

(a) *Minimum asset size.* Its quarter-end total assets exceed ten million dollars ($10,000,000); and

(b) *Minimum RBNW calculation.* Its risk-based net worth requirement as calculated under § 702.106 exceeds six percent (6%).

§ 702.104 Risk portfolios defined.

A risk portfolio is a portfolio of assets, liabilities, or contingent liabilities as specified below, each expressed as a percentage of the credit union's quarter-end total assets reflected in its most recent Call Report, rounded to two decimal places (Table 2):

(a) *Long-term real estate loans.* Total real estate loans and real estate lines of credit outstanding, exclusive of those outstanding that will contractually refinance, reprice or mature within the next five (5) years, and exclusive of all member business loans (as defined in 12 CFR 723.1 or as approved under 12 CFR 723.20);

(b) *Member business loans outstanding.* All member business loans as defined in 12 CFR 723.1 or as approved under 12 CFR 723.20;

(c) *Investments.* Investments as defined by 12 CFR 703.150 or applicable State law, including investments in CUSOs (as defined by § 702.2(d));

(d) *Low-risk assets.* Cash on hand (*e.g.,* coin and currency, including vault, ATM and teller cash) and the NCUSIF deposit;

(e) *Average-risk assets.* One hundred percent (100%) of total assets minus the sum of the risk portfolios in paragraphs (a) through (d) of this section;

(f) *Loans sold with recourse.* Outstanding balance of loans sold or swapped with recourse, excluding loans sold to the secondary mortgage market that have representations and warranties consistent with those customarily required by the U.S. Government and government sponsored enterprises;

(g) *Unused member business loan commitments.* Unused commitments for member business loans as defined in 12 CFR 723.1 or as approved under 12 CFR 723.20; and

(h) *Allowance.* The Allowance for Loan and Lease Losses not to exceed the equivalent of one and one-half percent (1.5%) of total loans outstanding.

TABLE 2 -- §702.104 RISK PORTFOLIOS DEFINED

Risk portfolio	*Assets, liabilities or contingent liabilities*
(a) Long-term real estate loans	Total real estate loans and real estate lines of credit (excluding MBLs) with a maturity (and next rate adjustment period if variable rate) greater than 5 years
(b) MBLs outstanding	Member business loans outstanding
(c) Investments	As defined by federal regulation or applicable State law.
(d) Low-risk assets	Cash on hand and NCUSIF deposit.
(e) Average-risk assets	100% of total assets minus sum of risk portfolios above
(f) Loans sold with recourse	Outstanding balance of loans sold or swapped with recourse, except for loans sold to the secondary mortgage market with a recourse period of 1 year or less.
(g) Unused MBL commitments	Unused commitments for MBLs
(h) Allowance	Allowance for Loan and Lease Losses limited to equivalent of 1.50 percent of total loans

§ 702.105 Weighted-average life of investments.

Except as provided below (Table 3), the weighted-average life of an investment for purposes of §§ 702.106(c) and 702.107(c) is defined pursuant to § 702.2(m):

(a) *Registered investment companies and collective investment funds.*

(1) For investments in registered investment companies (*e.g.,* mutual funds) and collective investment funds, the weighted-average life is defined as the maximum weighted-average life disclosed, directly or indirectly, in the prospectus or trust instrument;

(2) For investments in money market funds, as defined in 17 CFR 270.2a–7, and collective investment funds operated in accordance with short-term investment fund rules set forth in 12 CFR 9.18(b)(4)(ii)(B)(1)–(3), the weighted-average life is defined as one (1) year or less; and

(3) For other investments in registered investment companies or collective investment funds, the weighted-average life is defined as greater than five (5) years, but less than or equal to seven (7) years;

(b) *Callable fixed-rate debt obligations and deposits.* For fixed-rate debt obligations and deposits that are callable in whole, the weighted-average life is defined as the period remaining to the maturity date;

(c) *Variable-rate debt obligations and deposits.* For variable-rate debt obligations and deposits, the weighted-average life is defined as the period remaining to the next rate adjustment date;

(d) *Capital in mixed-ownership Government corporations and corporate credit unions.* For capital stock in mixed-ownership Government corporations, as defined in 31 U.S.C. 9101(2), and member paid-in capital and membership capital in corporate credit unions, as defined in 12 CFR 704.2, the weighted-average life is defined as greater than one (1) year, but less than or equal to three (3) years;

(e) *Investments in CUSOs.* For investments in CUSOs (as defined in § 702.2(d)), the weighted-average life is defined as greater than one (1) year, but less than or equal to three (3) years; and

(f) *Other equity securities.* For other equity securities, the weighted average life is defined as greater than ten (10) years.

TABLE 3 -- §702.105 WEIGHTED-AVERAGE LIFE OF INVESTMENTS

Investment	*Weighted-average life*
(a) Registered investment companies and collective investment funds	i. *Registered investment companies and collective investment funds*: As disclosed in prospectus or trust instrument, but if not disclosed, greater than five (5) years, but less than or equal to seven (7) years. ii. *Money market funds and STIFs*: One (1) year or less.
(b) Callable fixed-rate debt obligations and deposits	Period remaining to maturity date.
(c) Variable-rate debt obligations and deposits	Period remaining to next rate adjustment date.
(d) Capital in mixed-ownership Government corporations and corporate credit unions	Greater than one (1) year, but less than or equal to three (3) years.
(e) Investments in CUSOs	Greater than one (1) year, but less than or equal to three (3) years.
(f) Other equity securities	Greater than ten (10) years.

§ 702.106 Standard calculation of risk-based net worth requirement.

A credit union's risk-based net worth requirement is the aggregate of the following standard component amounts, each expressed as a percentage of the credit union's quarter-end total assets as reflected in its most recent Call Report, rounded to two decimal places (Table 4):

(a) *Long-term real estate loans.* The sum of:

(1) Six percent (6%) of the amount of long-term real estate loans less than or equal to twenty-five percent (25%) of total assets; and

(2) Fourteen percent (14%) of the amount in excess of twenty-five percent (25%) of total assets;

(b) *Member business loans outstanding.* The sum of:

(1) Six percent (6%) of the amount of member business loans outstanding less than or equal to twelve and one-quarter percent (12.25%) of total assets; and

(2) Fourteen percent (14%) of the amount in excess of twelve and one-quarter percent (12.25%) of total assets;

(c) *Investments.* The sum of:

(1) Three percent (3%) of the amount of investments with a weighted-average life (as specified in § 702.105 above) of one (1) year or less;

(2) Six percent (6%) of the amount of investments with a weighted-average life greater than one (1) year, but less than or equal to three (3) years;

(3) Twelve percent (12%) of the amount of investments with a weighted-average life greater than three (3) years, but less than or equal to ten (10) years; and

(4) Twenty percent (20%) of the amount of investments with a weighted-average life greater than ten (10) years;

(d) *Low-risk assets.* Zero percent (0%) of the entire portfolio of low-risk assets;

(e) *Average-risk assets.* Six percent (6%) of the entire portfolio of average-risk assets;

(f) *Loans sold with recourse.* Six percent (6%) of the entire portfolio of loans sold with recourse;

(g) *Unused member business loan commitments.* Six percent (6%) of the entire portfolio of unused member business loan commitments; and

(h) *Allowance.* Negative one hundred percent (−100%) of the balance of the Allowance for Loan and Lease Losses account, not to exceed the equivalent of one and one-half percent (1.5%) of total loans outstanding.

TABLE 4 -- §702.106 STANDARD CALCULATION OF RBNW REQUIREMENT

Risk portfolio	*Amount of risk portfolio (as percent of quarter-end total assets) to be multiplied by risk weighting*	*Risk weighting*
(a) Long-term real estate loans	0 to 25.00% over 25.00%	.06 .14
(b) MBLs outstanding	0 to 12.25% over 12.25%	.06 .14
(c) Investments	*By weighted-average life*: 0 to 1 year >1year to 3 years >3 years to 10 years >10 years	.03 .06 .12 .20
(d) Low-risk assets	All %	.00
(e) Average-risk assets	All %	.06
(f) Loans sold with recourse	All %	.06
(g) Unused MBL commitments	All %	.06
(h) Allowance	Limited to equivalent of 1.50% of total loans (expressed as a percent of total assets)	(1.00)
A credit union's RBNW requirement is the sum of eight standard components. A standard component is calculated for each of the eight risk portfolios, equal to the sum of each amount of a risk portfolio times its risk weighting. A credit union is classified "undercapitalized" if its net worth ratio is less than its applicable RBNW requirement.		

§ 702.107 Alternative components for standard calculation.

A credit union may substitute one or more alternative components below, in place of the corresponding standard components in § 702.106 above, when any alternative component amount, expressed as a percentage of the credit union's quarter-end total assets as reflected in its most recent Call Report, rounded to two decimal places, is smaller (Table 5):

(a) *Long-term real estate loans.* The sum of:

(1) *Non-callable.* Non-callable long-term real estate loans as follows:

(i) Eight percent (8%) of the amount of such loans with a remaining maturity of greater than 5 years, but less than or equal to 12 years;

(ii) Twelve percent (12%) of the amount of such loans with a remaining maturity of greater than 12 years, but less than or equal to 20 years; and

(iii) Fourteen percent (14%) of the amount of such loans with a remaining maturity greater than 20 years;

(2) *Callable.* Long-term real estate loans callable in 5 years or less as follows:

(i) Six percent (6%) of the amount of such loans with a documented call provision of 5 years or less and with a remaining maturity of greater than 5 years, but less than or equal to 12 years;

(ii) Ten percent (10%) of the amount of such loans with a documented call provision of 5 years or less and with a remaining maturity of greater than 12 years, but less than or equal to 20 years; and

(iii) Twelve percent (12%) of the amount of such loans with a documented call provision of 5 years or less and with a remaining maturity of greater than 20 years;

(b) *Member business loans outstanding.* The sum of:

(1) *Fixed rate.* Fixed-rate member business loans outstanding as follows:

(i) Six percent (6%) of the amount of such loans with a remaining maturity of 3 or fewer years;

(ii) Nine percent (9%) of the amount of such loans with a remaining maturity greater than 3 years, but less than or equal to 5 years;

(iii) Twelve percent (12%) of the amount of such loans with a remaining maturity greater than 5 years, but less than or equal to 7 years;

(iv) Fourteen percent (14%) of the amount of such loans with a remaining maturity greater than 7 years, but less than or equal to 12 years; and

(v) Sixteen percent (16%) of the amount of such loans with a remaining maturity greater than 12 years; and

(2) *Variable-rate.* Variable-rate member business loans outstanding as follows:

(i) Six percent (6%) of the amount of such loans with a remaining maturity of 3 or fewer years;

(ii) Eight percent (8%) of the amount of such loans with a remaining maturity greater than 3 years, but less than or equal to 5 years;

(iii) Ten percent (10%) of the amount of such loans with a remaining maturity greater than 5 years, but less than or equal to 7 years;

(iv) Twelve percent (12%) of the amount of such loans with a remaining maturity greater than 7 years, but less than or equal to 12 years; and

(v) Fourteen percent (14%) of the amount of such loans with a remaining maturity greater than 12 years.

(c) *Investments.* The sum of:

(1) Three percent (3%) of the amount of investments with a weighted-average life (as specified in § 702.105 above) of one (1) year or less;

(2) Six percent (6%) of the amount of investments with a weighted-average life greater than one (1) year, but less than or equal to three (3) years;

(3) Eight percent (8%) of the amount of investments with a weighted-average life greater than three (3) years, but less than or equal to five (5) years;

(4) Twelve percent (12%) of the amount of investments with a weighted-average life greater than five (5) years, but less than or equal to seven (7) years;

(5) Sixteen percent (16%) of the amount of investments with a weighted-average life greater than seven (7) years, but less than or equal to ten (10) years; and

(6) Twenty percent (20%) of the amount of investments with a weighted-average life greater than ten (10) years.

(d) *Loans sold with recourse.* The alternative component is the sum of:

(1) Six percent (6%) of the amount of loans sold with contractual recourse obligations of six percent (6%) or greater; and

(2) The weighted average recourse percent of the amount of loans sold with contractual recourse obligations of less than six percent (6%), as computed by the credit union.

TABLE 5 -- §702.107 ALTERNATIVE COMPONENTS FOR STANDARD CALCULATION

(a) LONG-TERM REAL ESTATE LOANS

Amount of long-term real estate loans by remaining maturity	*Alternative risk weighting*
Non-callable long-term real estate loans	
Remaining maturity:	
> 5 years to 12 years	.08
> 12 years to 20 years	.12
> 20 years	.14
Long-term real estate loans callable in 5 years or less	
Remaining maturity:	
> 5 years to 12 years	.06
> 12 years to 20 years	.10
> 20 years	.12
The "alternative component" is the sum of each amount of the "long-term real estate loans" risk portfolio by non-"callable" and "callable" characteristic and by remaining maturity (as a percent of quarter-end total assets) times its alternative factor. Substitute for corresponding standard component if smaller.	

(b) MEMBER BUSINESS LOANS

Amount of member business loans by remaining maturity	*Alternative risk weighting*
Fixed-rate MBLs	
0 to 3 years	.06
> 3 years to 5 years	.09
> 5 years to 7 years	.12
> 7 years to 12 years	.14
> 12 years	.16
Variable-rate MBLs	
0 to 3 years	.06
> 3 years to 5 years	.08
> 5 years to 7 years	.10
> 7 years to 12 years	.12
> 12 years	.14
The "alternative component" is the sum of each amount of the member business loans risk portfolio by fixed and variable rate and by remaining maturity (as a percent of quarter-end total assets) times its alternative factor. Substitute for corresponding standard component if smaller.	

(c) INVESTMENTS

Amount of investments by weighted-average life	*Alternative risk weighting*
0 to 1 year	.03
>1 year to 3 years	.06
>3 years to 5 years	.08
>5 years to 7 years	.12
>7 years to 10 years	.16
> 10 years	.20
The "alternative component" is the sum of each amount of the Investments risk portfolio by weighted-average life (as a percent of quarter-end total assets) times its alternative factor. Substitute for corresponding standard component if smaller.	

(d) LOANS SOLD WITH RECOURSE

Amount of loans by recourse	*Alternative risk weighting*
Recourse 6% or greater	.06
Recourse <6%	Weighted average recourse percent
The "alternative component" is the sum of each amount of the "loans sold with recourse" risk portfolio by level of recourse (as a percent of quarter-end total assets) times its alternative factor. The alternative factor for loans sold with recourse of less than 6% is equal to the weighted average recourse percent on such loans. A credit union must compute the weighted average recourse percent for its loans sold with recourse of less than six percent (6%). Substitute for corresponding standard component if smaller.	

§ 702.108 Risk mitigation credit.

(a) *Who may apply.* A credit union may apply for a risk mitigation credit if on any of the current or three preceding effective dates of classification it either failed an applicable RBNW requirement or met it by less than 100 basis points.

(b) *Application for credit.* Upon application pursuant to guidelines duly adopted by the NCUA Board, the NCUA Board may in its discretion grant a credit to reduce a risk-based net worth requirement under §§ 702.106 and 702.107 upon proof of mitigation of:

(1) Credit risk; or

(2) Interest rate risk as demonstrated by economic value exposure measures.

(c) *Application by FISCU.* In the case of a FISCU seeking a risk mitigation credit—

(1) Before an application under paragraph (a) above may be submitted to the NCUA Board, it must be submitted in duplicate to the appropriate State official and the appropriate Regional Director; and

(2) The NCUA Board, when evaluating the application of a FISCU, shall consult and seek to work cooperatively with the appropriate State official, and shall provide prompt notice of its decision to the appropriate State official.

APPENDICES A–H TO SUBPART A OF PART 702

APPENDIX A – EXAMPLE STANDARD COMPONENTS FOR RBNW REQUIREMENT, §702.106

(EXAMPLE CALCULATION IN BOLD)

Risk portfolio	*Dollar balance*	*Amount as percent of quarter-end total assets*	*Risk weighting*	*Amount times risk weighting*	*Standard component*
Quarter-end total assets	**200,000,000**	**100.0000 %**			
(a) Long-term real estate loans	**60,000,000**	**30.0000 % =**			**2.20 %**
Threshold amount: 0 to 25%		**25.0000 %**	.06	**1.5000 %**	
Excess amount: over 25%		**5.0000 %**	.14	**0.7000 %**	
(b) MBLs outstanding	**25,000,000**	**12.5000 % =**			**0.77 %**
Threshold amount: 0 to 12.25%		**12.2500 %**	.06	**0.7350 %**	
Excess amount: over 12.25%		**0.2500 %**	.14	**0.0350 %**	
(c) Investments	**50,000,000 =**	**25.0000 % =**			**1.51 %**
Weighted-average life:					
0 to 1 year	**24,000,000**	**12.0000 %**	.03	**0.3600 %**	
>1 year to 3 years	**15,000,000**	**7.5000 %**	.06	**0.4500 %**	
>3 years to 10 years	**10,000,000**	**5.0000 %**	.12	**0.6000 %**	
>10 years	**1,000,000**	**0.5000 %**	.20	**0.1000 %**	
(d) Low-risk assets	**4,000,000**	**2.0000 %**	.00		**0 %**
Sum of risk portfolios (a) through (d) above	**139,000,000**	**69.5000 %**			
(e) Average-risk assets	**61,000,000**	**30.5000 %**[a/]	.06		**1.83 %**
(f) Loans sold with recourse	**40,000,000**	**20.0000 %**	.06		**1.20 %**
(g) Unused MBL commitments	**5,000,000**	**2.5000 %**	.06		**0.15 %**
(h) Allowance	**2,040,000.00** [b/]	**1.0200 %**	(1.00)		**(1.02) %**
Sum of standard components: **RBNW requirement** [c/]					**6.64 %**

[a/] The Average-risk assets risk portfolio percent of quarter-end total assets equals 100 percent minus the sum of the percentages in the four risk portfolios above (i.e., Long-term real estate loans, MBLs outstanding, Investments, and Low-risk assets).

[b/] The Allowance risk portfolio is limited to the equivalent of 1.50 percent of total loans. For an example computation of the permitted dollar balance of Allowance, see worksheet in Appendix B below.

[c/] A credit union is classified "undercapitalized" if its net worth ratio is less than its applicable RBNW requirement. The dollar equivalent of RBNW requirement may be computed for informational purposes as the RBNW requirement percent of total assets.

APPENDIX B – ALLOWANCE RISK PORTFOLIO DOLLAR BALANCE WORKSHEET
(EXAMPLE CALCULATION IN BOLD)

Balance sheet account	***Dollar balance***	***Percent of total loans***	*Range of ALL permitted*	***Permitted ALL percent of total loans***	***Permitted dollar balance of Allowance***
Allowance for Loan and Lease Losses (ALL)	**2,400,000**	**1.7647%**	0 to 1.50%	**1.50%**	**2,040,000**
Total loans	**136,000,000**				

APPENDIX C – EXAMPLE LONG-TERM REAL ESTATE LOANS ALTERNATIVE COMPONENT, §702.107(a)
(EXAMPLE CALCULATION IN BOLD)

Remaining maturity	**Dollar balance of Long-term real estate loans by remaining maturity**	**Percent of total assets by remaining maturity**	Alternative risk weighting	**Alternative component**
Non-callable long-term real estate loans				
> 5 years to 12 years	**15,000,000**	**7.5000 %**	.08	**0.6000 %**
> 12 years to 20 years	**2,500,000**	**1.2500 %**	.12	**0.1500 %**
> 20 years	**2,500,000**	**1.2500 %**	.14	**0.1750 %**
Long-term real estate loans callable in 5 years or less				
> 5 years to 12 years	**35,000,000**	**17.5000 %**	.06	**1.0500 %**
> 12 years to 20 years	**5,000,000**	**2.5000 %**	.10	**0.2500 %**
> 20 years	**0**	**0.000 %**	.12	**0.000 %**
Sum of above equals Alternative Component*				**2.23 %**

*Substitute for standard component if lower.

APPENDIX D – EXAMPLE OF MEMBER BUSINESS LOANS ALTERNATIVE COMPONENT, §702.107(b)
(EXAMPLE CALCULATION IN BOLD)

Remaining maturity	***Dollar balance of MBLs by remaining maturity***	***Percent of total assets by remaining maturity***	*Alternative risk weighting*	***Alternative component***
Fixed-rate MBLs				
0 to 3 years	**6,000,000**	**3.0000 %**	.06	**0.1800 %**
> 3 years to 5 years	**4,000,000**	**2.0000 %**	.09	**0.1800 %**
> 5 years to 7 years	**2,000,000**	**1.0000 %**	.12	**0.1200 %**
> 7 years to 12 years	**0**	**0.0000 %**	.14	**0.0000 %**
> 12 years	**0**	**0.0000 %**	.16	**0.0000 %**
Variable-rate MBLs				
0 to 3 years	**7,000,000**	**3.5000 %**	.06	**0.2100 %**
> 3 years to 5 years	**4,000,000**	**2.0000 %**	.08	**0.1600 %**
> 5 years to 7 years	**2,000,000**	**1.0000 %**	.10	**0.1000 %**
> 7 years to 12 years	**0**	**0.0000 %**	.12	**0.0000 %**
>12 years	**0**	**0.0000 %**	.14	**0.0000 %**
Sum of above equals Alternative component*				**0.95 %**

* Substitute for standard component if lower.

APPENDIX E -- EXAMPLE OF INVESTMENTS ALTERNATIVE COMPONENT, §702.107(c)
(EXAMPLE CALCULATION IN BOLD)

Weighted-average life	***Dollar balance of investments by weighted-average life***	***Percent of total assets by weighted-average life***	*Alternative risk weighting*	***Alternative component***
0 to 1 year	**24,000,000**	**12.0000 %**	.03	**0.3600 %**
> 1 year to 3 years	**15,000,000**	**7.5000 %**	.06	**0.4500 %**
> 3 years to 5 years	**8,000,000**	**4.0000 %**	.08	**0.3200 %**
> 5 years to 7 years	**1,000,000**	**0.5000 %**	.12	**0.0600 %**
> 7 years to 10 years	**1,000,000**	**0.5000 %**	.16	**0.0800 %**
> 10 years	**1,000,000**	**0.5000 %**	.20	**0.1000 %**
Sum of above equals Alternative component*				**1.37 %**

* Substitute for standard component if lower.

APPENDIX F – EXAMPLE LOANS SOLD WITH RECOURSE ALTERNATIVE COMPONENT, §702.107(d)
(EXAMPLE CALCULATION IN BOLD)

Percent of contractual recourse obligation	***Dollar balance of Loans sold with recourse***	***Percent of total assets***	***Alternative risk weighting***	***Alternative component***
Recourse 6 % or greater	**5,000,000**	**2.5000 %**	.06	**0.1500 %**
Recourse < 6 %	**35,000,000**	**17.5000 %**	.0500 [a/]	**0.8750 %**
Sum of above equals Alternative component*				**1.03 %**

* Substitute for corresponding standard component if lower.

[a/] The credit union must calculate this alternative risk weighting for loans sold with recourse of less than 6 %. For an example computation, see worksheet in Appendix G below.

APPENDIX G –WORKSHEET FOR ALTERNATIVE RISK WEIGHTING OF LOANS SOLD WITH CONTRACTUAL RECOURSE OBLIGATIONS OF LESS THAN 6 %
(EXAMPLE CALCULATION IN BOLD)

Percent of contractual recourse obligation less than 6%	***Dollar balance of loans sold with recourse***	***Dollars of recourse***	***Alternative risk weighting***
5.50 %	**5,000,000**	**275,000**	
5.00 %	**25,000,000**	**1,250,000**	
4.50 %	**5,000,000**	**225,000**	
Sum of above equals	**35,000,000**	**1,750,000**	
Dollar of recourse divided by dollar balance equals (expressed as %)			**5.00 %**

APPENDIX H -- EXAMPLE RBNW REQUIREMENT USING ALTERNATIVE COMPONENTS
(EXAMPLE CALCULATION IN BOLD)

Risk portfolio	***Standard component***	***Alternative component***	***Lower of standard or alternative component***
(a) Long-term real estate loans	**2.20 %**	**2.85 %**	**2.20 %**
(b) MBLs outstanding	**0.77 %**	**0.95 %**	**0.77 %**
(c) Investments	**1.51 %**	**1.37 %**	**1.37 %**
(f) Loans sold with recourse	**1.20%**	**1.03%**	**1.03%**
			Standard component
(d) Low-risk assets			**0 %**
(e) Average-risk assets			**1.83 %**
(g) Unused MBL commitments			**0.15 %**
(h) Allowance			**(1.02) %**
RBNW requirement* Compare to Net Worth Ratio			**6.33 %**

* A credit union is "undercapitalized" if its net worth ratio is less than its applicable RBNW requirement.

Subpart B—Mandatory and Discretionary Supervisory Actions

§ 702.201 Prompt corrective action for "adequately capitalized" credit unions.

(a) *Earnings retention.* Beginning the effective date of classification as "adequately capitalized" or lower, a federally-insured credit union must increase the dollar amount of its net worth quarterly either in the current quarter, or on average over the current and three preceding quarters, by an amount equivalent to at least 1/10th percent (0.1%) of its total assets, and must quarterly transfer that amount (or more by choice) from undivided earnings to its regular reserve account until it is "well capitalized."

(b) *Decrease in retention.* Upon written application received no later than 14 days before the quarter end, the NCUA Board, on a case-by-case basis, may permit a credit union to increase the dollar amount of its net worth and quarterly transfer an amount that is less than the amount required under paragraph (a) of this section, to the extent the NCUA Board determines that such lesser amount—

(1) Is necessary to avoid a significant redemption of shares; and

(2) Would further the purpose of this part.

(c) *Decrease by FISCU.* The NCUA Board shall consult and seek to work cooperatively with the appropriate State official before permitting a federally-insured State-chartered credit union to decrease its earnings retention under paragraph (b) of this section.

(d) *Periodic review.* A decision under paragraph (b) of this section to permit a credit union to decrease its earnings retention is subject to quarterly review and revocation except when the credit union is operating under an approved net worth restoration plan that provides for decreasing its earnings retention as provided under paragraph (b).

§ 702.202 Prompt corrective action for "undercapitalized" credit unions

(a) *Mandatory supervisory actions by credit union.* A federally-insured credit union which is "undercapitalized" must—

(1) *Earnings retention.* Increase net worth and transfer earnings to its regular reserve account in accordance with § 702.201;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.206, *provided however,* that a credit union in this category having a net worth ratio of less

than five percent (5%) which fails to timely submit such a plan, or which materially fails to implement an approved plan, is classified "significantly undercapitalized" pursuant to § 702.102(a)(4)(ii) above;

(3) *Restrict increase in assets.* Beginning the effective date of classification as "undercapitalized" or lower, not permit the credit union's assets to increase beyond its total assets (per § 702.2(j)) for the preceding quarter unless—

(i) *Plan approved.* The NCUA Board has approved a net worth restoration plan which provides for an increase in total assets and—

(A) The assets of the credit union are increasing consistent with the approved plan; and

(B) The credit union is implementing steps to increase the net worth ratio consistent with the approved plan;

(ii) *Plan not approved.* The NCUA Board has not approved a net worth restoration plan and total assets of the credit union are increasing because of increases since quarter-end in balances of:

(A) Total accounts receivable and accrued income on loans and investments; or

(B) Total cash and cash equivalents; or

(C) Total loans outstanding, not to exceed the sum of total assets (per § 702.2(j)) plus the quarter-end balance of unused commitments to lend and unused lines of credit provided however that a credit union which increases a balance as permitted under paragraphs (A), (B) or (C) cannot offer rates on shares in excess of prevailing rates on shares in its relevant market area, and cannot open new branches;

(4) *Restrict member business loans.* Beginning the effective date of classification as "undercapitalized" or lower, not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as of the preceding quarter-end unless it is granted an exception under 12 U.S.C. 1757a(b).

(b) *"Second tier" discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to an "undercapitalized" credit union having a net worth ratio of less than five percent (5%), or a director, officer or employee of such a credit union, if it determines that those actions are necessary to carry out the purpose of this part:

(1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, unless the NCUA Board has approved the credit union's net worth restoration plan, the credit union is implementing its plan, and the NCUA Board determines that the proposed action is consistent with and will further the objectives of that plan;

(2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to reduce or divest its ownership interest in a CUSO;

(3) *Restricting dividends paid.* Restrict the dividend rates the credit union pays on shares to the prevailing rates paid on comparable accounts and maturities in the relevant market area, as determined by the NCUA Board, except that dividend rates already declared on shares acquired before imposing a restriction under this paragraph may not be retroactively restricted;

(4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce its assets or a category of assets;

(5) *Alter, reduce or terminate activity.* Require the credit union or its CUSO to alter, reduce, or terminate any activity which poses excessive risk to the credit union;

(6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;

(7) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however,* that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);

(8) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval); and

(9) *Other action to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board deter-

mines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (8) of this section.

(c) *"First tier" application of discretionary supervisory actions.* An "undercapitalized" credit union having a net worth ratio of five percent (5%) or more, or which is classified "undercapitalized" by reason of failing to satisfy a risk-based net worth requirement under § 702.105 or 702.106, is subject to the discretionary supervisory actions in paragraph (b) of this section if it fails to comply with any mandatory supervisory action in paragraph (a) of this section or fails to timely implement an approved net worth restoration plan under § 702.206, including meeting its prescribed steps to increase its net worth ratio.

§ 702.203 Prompt corrective action for "significantly undercapitalized" credit unions.

(a) *Mandatory supervisory actions by credit union.* A federally-insured credit union which is "significantly undercapitalized" must—

(1) *Earnings retention.* Increase net worth and transfer earnings to its regular reserve account in accordance with § 702.201;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.206;

(3) *Restrict increase in assets.* Not permit the credit union's total assets to increase except as provided in § 702.202(a)(3) and

(4) *Restrict member business loans.* Not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as provided in § 702.202(a)(4).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to any "significantly undercapitalized" credit union, or a director, officer or employee of such credit union, if it determines that those actions are necessary to carry out the purpose of this part:

(1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, except as provided in § 702.202(b)(1);

(2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to divest or reduce its ownership interest in a CUSO;

(3) *Restricting dividends paid.* Restrict the dividend rates that the credit union pays on shares as provided in § 702.202(b)(3);

(4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce assets or a category of assets;

(5) *Alter, reduce or terminate activity.* Require the credit union or its CUSO(s) to alter, reduce, or terminate any activity which poses excessive risk to the credit union;

(6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;

(7) *New election of directors.* Order a new election of the credit union's board of directors;

(8) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however,* that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);

(9) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval);

(10) *Restricting senior executive officers' compensation.* Except with the prior written approval of the NCUA Board, limit compensation to any senior executive officer to that officer's average rate of compensation (excluding bonuses and profit sharing) during the four (4) calendar quarters preceding the effective date of classification of the credit union as "significantly undercapitalized," and prohibit payment of a bonus or profit share to such officer;

(11) *Other actions to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board determines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (10) of this section; and

(12) *Requiring merger.* Require the credit union to merge with another financial institution if one or more grounds exist for placing the

credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i).

(c) *Discretionary conservatorship or liquidation if no prospect of becoming "adequately capitalized."* Notwithstanding any other actions required or permitted to be taken under this section, when a credit union becomes "significantly undercapitalized" (including by reclassification under section 702.102(b) above), the NCUA Board may place the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i), provided that the credit union has no reasonable prospect of becoming "adequately capitalized."

§ 702.204 Prompt corrective action for "critically undercapitalized" credit unions

(a) *Mandatory supervisory actions by credit union.* A federally-insured credit union which is "critically undercapitalized" must—

(1) *Earnings retention.* Increase net worth and transfer earnings to its regular reserve account in accordance with § 702.201;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.206;

(3) *Restrict increase in assets.* Not permit the credit union's total assets to increase except as provided in § 702.202(a)(3); and

(4) *Restrict member business loans.* Not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as provided in § 702.202(a)(4).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to any "critically undercapitalized" credit union, or a director, officer or employee of such credit union, if it determines that those actions are necessary to carry out the purpose of this part:

(1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, except as provided by § 702.202(b)(1);

(2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to divest or reduce its ownership interest in a CUSO;

(3) *Restricting dividends paid.* Restrict the dividend rates that the credit union pays on shares as provided in § 702.202(b)(3);

(4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce assets or a category of assets;

(5) *Alter, reduce or terminate activity.* Require the credit union or its CUSO(s) to alter, reduce, or terminate any activity which poses excessive risk to the credit union;

(6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;

(7) *New election of directors.* Order a new election of the credit union's board of directors;

(8) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however,* that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);

(9) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval);

(10) *Restricting senior executive officers' compensation.* Reduce or, with the prior written approval of the NCUA Board, limit compensation to any senior executive officer to that officer's average rate of compensation (excluding bonuses and profit sharing) during the four (4) calendar quarters preceding the effective date of classification of the credit union as "critically undercapitalized," and prohibit payment of a bonus or profit share to such officer;

(11) *Restrictions on payments on uninsured secondary capital.* Beginning 60 days after the effective date of classification of a credit union as "critically undercapitalized," prohibit payments of principal, dividends or interest on the credit union's uninsured secondary capital accounts established after August 7, 2000, except that unpaid dividends or interest shall continue to accrue under the terms of the account to the extent permitted by law;

(12) *Requiring prior approval.* Require a "critically undercapitalized" credit union to obtain the NCUA Board's prior written approval before doing any of the following:

(i) Entering into any material transaction not within the scope of an approved net worth restoration plan (or approved revised business plan under subpart C of this part);

(ii) Extending credit for transactions deemed highly leveraged by the NCUA Board or, if State-chartered, by the appropriate State official;

(iii) Amending the credit union's charter or bylaws, except to the extent necessary to comply with any law, regulation, or order;

(iv) Making any material change in accounting methods; and

(v) Paying dividends or interest on new share accounts at a rate exceeding the prevailing rates of interest on insured deposits in its relevant market area;

(13) *Other action to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board determines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (12) of this section; and

(14) *Requiring merger.* Require the credit union to merge with another financial institution if one or more grounds exist for placing the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i).

(c) *Mandatory conservatorship, liquidation or action in lieu thereof*—(1) *Action within 90 days.* Notwithstanding any other actions required or permitted to be taken under this section (and regardless of a credit union's prospect of becoming "adequately capitalized"), the NCUA Board must, within 90 calendar days after the effective date of classification of a credit union as "critically undercapitalized"—

(i) *Conservatorship.* Place the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(G); or

(ii) *Liquidation.* Liquidate the credit union pursuant to 12 U.S.C. 1787(a)(3)(A)(ii); or

(iii) *Other corrective action.* Take other corrective action, in lieu of conservatorship or liquidation, to better achieve the purpose of this part, provided that the NCUA Board documents why such action in lieu of conservatorship or liquidation would do so, *provided however,* that other corrective action may consist, in whole or in part, of complying with the quarterly timetable of steps and meeting the quarterly net worth targets prescribed in an approved net worth restoration plan.

(2) *Renewal of other corrective action.* A determination by the NCUA Board to take other corrective action in lieu of conservatorship or liquidation under paragraph (c)(1)(iii) of this section shall expire after an effective period ending no later than 180 calendar days after the determination is made, and the credit union shall be immediately placed into conservatorship or liquidation under paragraphs (c)(1)(i) and (ii), unless the NCUA Board makes a new determination under paragraph (c)(1)(iii) of this section before the end of the effective period of the prior determination;

(3) *Mandatory liquidation after 18 months*—(i) *Generally.* Notwithstanding paragraphs (c)(1) and (2) of this section, the NCUA Board must place a credit union into liquidation if it remains "critically undercapitalized" for a full calendar quarter, on a monthly average basis, following a period of 18 months from the effective date the credit union was first classified "critically undercapitalized."

(ii) *Exception.* Notwithstanding paragraph (c)(3)(i) of this section, the NCUA Board may continue to take other corrective action in lieu of liquidation if it certifies that the credit union—

(A) Has been in substantial compliance with an approved net worth restoration plan requiring consistent improvement in net worth since the date the net worth restoration plan was approved;

(B) Has positive net income or has an upward trend in earnings that the NCUA Board projects as sustainable; and

(C) Is viable and not expected to fail.

(iii) *Review of exception.* The NCUA Board shall, at least quarterly, review the certification of an exception to liquidation under paragraph (c)(3)(ii) of this section and shall either—

(A) Recertify the credit union if it continues to satisfy the criteria of paragraph (c)(3)(ii) of this section; or

(B) Promptly place the credit union into liquidation, pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), if it fails to satisfy the criteria of paragraph (c)(3)(ii) of this section.

(4) *Nondelegation.* The NCUA Board may not delegate its authority under paragraph (c) of this section, unless the credit union has less

than $5,000,000 in total assets. A credit union shall have a right of direct appeal to the NCUA Board of any decision made by delegated authority under this section within ten (10) calendar days of the date of that decision.

(d) *Mandatory liquidation of insolvent federal credit union.* In lieu of paragraph (c) of this section, a "critically undercapitalized" federal credit union that has a net worth ratio of less than zero percent (0%) may be placed into liquidation on grounds of insolvency pursuant to 12 U.S.C. 1787(a)(1)(A).

§ 702.205 Consultation with State officials on proposed prompt corrective action.

(a) *Consultation on proposed conservatorship or liquidation.* Before placing a federally-insured State-chartered credit union into conservatorship (pursuant to 12 U.S.C. 1786(h)(1)(F) or (G)) or liquidation (pursuant to 12 U.S.C. 1787(a)(3)) as permitted or required under subparts B or C of this part to facilitate prompt corrective action—

(1) The NCUA Board shall seek the views of the appropriate State official (as defined in § 702.2(b), and give him or her an opportunity to take the proposed action;

(2) The NCUA Board shall, upon timely request of the appropriate State official, promptly provide him or her with a written statement of the reasons for the proposed conservatorship or liquidation, and reasonable time to respond to that statement; and

(3) If the appropriate State official makes a timely written response that disagrees with the proposed conservatorship or liquidation and gives reasons for that disagreement, the NCUA Board shall not place the credit union into conservatorship or liquidation unless it first considers the views of the appropriate State official and determines that—

(i) The NCUSIF faces a significant risk of loss if the credit union is not placed into conservatorship or liquidation; and

(ii) Conservatorship or liquidation is necessary either to reduce the risk of loss, or to reduce the expected loss, to the NCUSIF with respect to the credit union.

(b) *Nondelegation.* The NCUA Board may not delegate any determination under paragraph (a)(3) of this section.

(c) *Consultation on proposed discretionary action.* The NCUA Board shall consult and seek to work cooperatively with the appropriate State official before taking any discretionary supervisory action under §§ 702.202(b), 702.203(b), 702.204(b), 702.304(b) and 702.305(b) with respect to a federally-insured State-chartered credit union; shall provide prompt notice of its decision to the appropriate State official; and shall allow the appropriate State official to take the proposed action independently or jointly with NCUA.

§ 702.206 Net worth restoration plans.

(a) *Schedule for filing*—(1) *Generally.* A federally-insured credit union shall file a written net worth restoration plan (NWRP) with the appropriate Regional Director and, if State-chartered, the appropriate State official, within 45 calendar days of the effective date of classification as either "undercapitalized," "significantly undercapitalized" or "critically undercapitalized," unless the NCUA Board notifies the credit union in writing that its NWRP is to be filed within a different period.

(2) *Exception.* An otherwise "adequately capitalized" credit union that is reclassified "undercapitalized" on safety and soundness grounds under § 702.102(b) is not required to submit a NWRP solely due to the reclassification, unless the NCUA Board notifies the credit union that it must submit an NWRP.

(3) *Filing of additional plan.* Notwithstanding paragraph (a)(1) of this section, a credit union that has already submitted and is operating under a NWRP approved under this section is not required to submit an additional NWRP due to a change in net worth category (including by reclassification under § 702.102(b)), unless the NCUA Board notifies the credit union that it must submit a new NWRP. A credit union that is notified to submit a new or revised NWRP shall file the NWRP in writing with the appropriate Regional Director within 30 calendar days of receiving such notice, unless the NCUA Board notifies the credit union in writing that the NWRP is to be filed within a different period.

(4) *Failure to timely file plan.* When a credit union fails to timely file an NWRP pursuant to this paragraph, the NCUA Board shall promptly notify the credit union that it has failed to file an NWRP and that it has 15 calendar days from receipt of that notice within which to file an NWRP.

(b) *Assistance to small credit unions.* Upon timely request by a credit union having total assets of less than $10 million (regardless how long it has been in operation), the NCUA Board shall provide assistance in preparing an NWRP required to be filed under paragraph (a) of this section.

(c) *Contents of NWRP.* An NWRP must—

(1) Specify—

(i) A quarterly timetable of steps the credit union will take to increase its net worth ratio so that it becomes "adequately capitalized" by the end of the term of the NWRP, and to remain so for four (4) consecutive calendar quarters. If "complex," the credit union is subject to a risk-based net worth requirement that may require a net worth ratio higher than six percent (6%) to become "adequately capitalized";

(ii) The projected amount of earnings to be transferred to the regular reserve account in each quarter of the term of the NWRP as required under § 702.201(a), or as permitted under § 702.201(b);

(iii) How the credit union will comply with the mandatory and any discretionary supervisory actions imposed on it by the NCUA Board under this subpart;

(iv) The types and levels of activities in which the credit union will engage; and

(v) If reclassified to a lower category under § 702.102(b), the steps the credit union will take to correct the unsafe or unsound practice(s) or condition(s);

(2) Include pro forma financial statements, including any off-balance sheet items, covering a minimum of the next two years; and

(3) Contain such other information as the NCUA Board has required.

(d) *Criteria for approval of NWRP.* The NCUA Board shall not accept a NWRP plan unless it—

(1) Complies with paragraph (c) of this section;

(2) Is based on realistic assumptions, and is likely to succeed in restoring the credit union's net worth; and (3) Would not unreasonably increase the credit union's exposure to risk (including credit risk, interest-rate risk, and other types of risk).

(e) *Consideration of regulatory capital.* To minimize possible long-term losses to the NCUSIF while the credit union takes steps to become "adequately capitalized," the NCUA Board shall, in evaluating an NWRP under this section, consider the type and amount of any form of regulatory capital which may become established by NCUA regulation, or authorized by State law and recognized by NCUA, which the credit union holds, but which is not included in its net worth.

(f) *Review of NWRP*—(1) *Notice of decision.* Within 45 calendar days after receiving an NWRP under this part, the NCUA Board shall notify the credit union in writing whether the NWRP has been approved, and shall provide reasons for its decision in the event of disapproval.

(2) *Delayed decision.* If no decision is made within the time prescribed in paragraph (f)(1) of this section, the NWRP is deemed approved.

(3) *Consultation with State officials.* In the case of an NWRP submitted by a federally-insured State-chartered credit union (whether an original, new, additional, revised or amended NWRP), the NCUA Board shall, when evaluating the NWRP, seek and consider the views of the appropriate State official, and provide prompt notice of its decision to the appropriate State official.

(g) *NWRP not approved* (1) *Submission of revised NWRP.* If an NWRP is rejected by the NCUA Board, the credit union shall submit a revised NWRP within 30 calendar days of receiving notice of disapproval, unless it is notified in writing by the NCUA Board that the revised NWRP is to be filed within a different period.

(2) *Notice of decision on revised NWRP.* Within 30 calendar days after receiving a revised NWRP under paragraph (g)(1) of this section, the NCUA Board shall notify the credit union in writing whether the revised NWRP is approved. The Board may extend the time within which notice of its decision shall be provided.

(3) *Disapproval of reclassified credit union's NWRP.* A credit union which has been classified "significantly undercapitalized" under § 702.102(a)(4)(ii) shall remain so classified pending NCUA Board approval of a new or revised NWRP.

(h) *Amendment of NWRP.* A credit union that is operating under an approved NWRP may, after prior written notice to, and approval by the NCUA Board, amend its NWRP to reflect a change in circumstance. Pending approval of an amended NWRP, the credit union shall implement the NWRP as originally approved.

(i) *Publication.* An NWRP need not be published to be enforceable because publication would be contrary to the public interest.

Subpart C—Alternative Prompt Corrective Action for New Credit Unions

§ 702.301 Scope and definition.

(a) *Scope.* This subpart C applies in lieu of subpart B of this part exclusively to credit unions defined in paragraph (b) of this section as "new" pursuant to 12 U.S.C. 1790d(b)(2).

(b) *New credit union defined.* A "new" credit union for purposes of this subpart is a federally-insured credit union that both has been in operation for less than ten (10) years and has total assets of not more than $10 million. A credit union which exceeds $10 million in total assets may become "new" if its total assets subsequently decline below $10 million while it is still in operation for less than 10 years.

(c) *Effect of spin-offs.* A credit union formed as the result of a "spin-off" of a group from the field of membership of an existing credit union is deemed to be in operation since the effective date of the "spin-off." A credit union whose total assets decline below $10 million because a group within its field of membership has been "spun-off" is deemed "new" if it has been in operation less than 10 years.

(d) *Actions to evade prompt corrective action.* If the NCUA Board determines that a credit union was formed, or was reduced in asset size as a result of a "spin-off," or was merged, primarily to qualify as "new" under this subpart, the credit union shall be deemed subject to prompt corrective action under subpart A of this part.

§ 702.302 Net worth categories for new credit unions.

(a) *Net worth measures.* For purposes of this part, a new credit union must determine its net worth category classification quarterly according to its net worth ratio as defined in § 702.2(g).

(b) *Effective date of net worth classification of new credit union.* For purposes of subpart C, the effective date of a new federally-insured credit union's classification within a net worth category in paragraph (c) of this section shall be determined as provided in § 702.101(b); and written notice to the NCUA Board of a decline in net worth category in paragraph (c) of this section shall be given as required by section 702.101(c).

(c) *Net worth categories.* A federally-insured credit union defined as "new" under this section shall be classified (Table 6)—

(1) *Well capitalized* if it has a net worth ratio of seven percent (7%) or greater;

(2) *Adequately capitalized* if it has a net worth ratio of six percent (6%) or more but less than seven percent (7%);

(3) *Moderately capitalized* if it has a net worth ratio of three and one-half percent (3.5%) or more but less than six percent (6%);

(4) *Marginally capitalized* if it has a net worth ratio of two percent (2%) or more but less than three and one-half percent (3.5%);

(5) *Minimally capitalized* if it has a net worth ratio of zero percent (0%) or greater but less than two percent (2%); and

(6) *Uncapitalized* if it has a net worth ratio of less than zero percent (0%) (*e.g.,* a deficit in retained earnings).

TABLE 6 -- NET WORTH CATEGORY CLASSIFICATION FOR "NEW" CREDIT UNIONS

A "new" credit union's net worth category is . . .	*if its net worth ratio is . . .*
"Well Capitalized"	7% or above
"Adequately Capitalized"	6% to 6.99%
"Moderately Capitalized"	3.5% to 5.99%
"Marginally Capitalized"	2% to 3.49%
"Minimally Capitalized"	0% to 1.99%
"Uncapitalized"	Less than 0%

(d) *Reclassification based on supervisory criteria other than net worth.* Subject to § 702.102(b) and (c), the NCUA Board may reclassify a "well capitalized," "adequately capitalized" or "moderately capitalized" new credit union to the next lower net worth category (each of such actions is hereinafter referred to generally as "reclassification") in either of the circumstances prescribed in § 702.102(b).

(e) *Consultation with State officials.* The NCUA Board shall consult and seek to work cooperatively with the appropriate State official before reclassifying a federally-insured State-chartered credit union under paragraph (d) of this section, and shall promptly notify the appropriate State official of its decision to reclassify.

§ 702.303 Prompt corrective action for "adequately capitalized" new credit unions.

Beginning on the effective date of classification, an "adequately capitalized" new credit union must increase the dollar amount of its net worth by the amount reflected in its approved initial or revised business plan in accordance with § 702.304(a)(2), or in the absence of such a plan, in accordance with § 702.201, and quarterly transfer that amount from undivided earnings to its regular reserve account, until it is "well capitalized."

§ 702.304 Prompt corrective action for "moderately capitalized," "marginally capitalized" or "minimally capitalized" new credit unions.

(a) *Mandatory supervisory actions by new credit union.* Beginning on the date of classification as "moderately capitalized," "marginally capitalized" or "minimally capitalized" (including by reclassification under § 702.302(d)), a new credit union must—

(1) *Earnings retention.* Increase the dollar amount of its net worth by the amount reflected in its approved initial or revised business plan and quarterly transfer that amount from undivided earnings to its regular reserve account;

(2) *Submit revised business plan.* Submit a revised business plan within the time provided by § 702.306 if the credit union either:

(i) Has not increased its net worth ratio consistent with its then-present approved business plan;

(ii) Has no then-present approved business plan; or

(iii) Has failed to comply with paragraph (a)(3) of this section; and

(3) *Restrict member business loans.* Not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as of the preceding quarter-end unless it is granted an exception under 12 U.S.C. 1757a(b).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures set forth in subpart L of part 747 of this chapter for issuing, reviewing and enforcing directives, the NCUA Board may, by directive, take one or more of the actions prescribed in § 702.204(b) if the credit union's net worth ratio has not increased consistent with its then-present business plan, or the credit union has failed to undertake any mandatory supervisory action prescribed in paragraph (a) of this section.

(c) *Discretionary conservatorship or liquidation.* Notwithstanding any other actions required or permitted to be taken under this section, the NCUA Board may place a new credit union which is "moderately capitalized," "marginally capitalized" or "minimally capitalized" (including by reclassification under § 702.302(d)) into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i), provided that the credit union has no reasonable prospect of becoming "adequately capitalized."

§ 702.305 Prompt corrective action for "uncapitalized" new credit unions.

(a) *Mandatory supervisory actions by new credit union.* Beginning on the effective date of classification as "uncapitalized," a new credit union must—

(1) *Earnings retention.* Increase the dollar amount of its net worth by the amount reflected in the credit union's approved initial or revised business plan;

(2) *Submit revised business plan.* Submit a revised business plan within the time provided by § 702.306, providing for alternative means of funding the credit union's earnings deficit, if the credit union either:

(i) Has not increased its net worth ratio consistent with its then-present approved business plan;

(ii) Has no then-present approved business plan; or

(iii) Has failed to comply with paragraph (a)(3) of this section; and

(3) *Restrict member business loans.* Not increase the total dollar amount of member business loans as provided in § 702.304(a)(3).

(b) *Discretionary supervisory actions by NCUA.* Subject to the procedures set forth in subpart L of part 747 of this chapter for issuing, reviewing and enforcing directives, the NCUA Board may, by directive, take one or more of the actions prescribed in § 702.204(b) if the credit union's net worth ratio has not increased consistent with its then-present business plan, or the credit union has failed to undertake any mandatory supervisory action prescribed in paragraph (a) of this section.

(c) *Mandatory liquidation or conservatorship.* Notwithstanding any other actions required or permitted to be taken under this section, the NCUA Board—

(1) *Plan not submitted.* May place into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), or conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), an "uncapitalized" new credit union which fails to submit a revised business plan within the time provided under paragraph (a)(2) of this section; or

(2) *Plan rejected, approved, implemented.* Except as provided in paragraph (c)(3) of this section, must place into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), or conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), an "uncapitalized" new credit union that remains "uncapitalized" one hundred twenty (120) calendar days after the later of:

(i) The effective date of classification as "uncapitalized"; or

(ii) The last day of the calendar month following expiration of the time period provided in the credit union's initial business plan (approved at the time its charter was granted) to remain "uncapitalized," regardless whether a revised business plan was rejected, approved or implemented.

(3) *Exception.* The NCUA Board may decline to place a new credit union into liquidation or conservatorship as provided in paragraph (c)(2) of this section if the credit union documents to the NCUA Board why it is viable and has a reasonable prospect of becoming "adequately capitalized."

(d) *Mandatory liquidation of "uncapitalized" federal credit union.* In lieu of paragraph (c) of this section, an "uncapitalized" federal credit union may be placed into liquidation on grounds of insolvency pursuant to 12 U.S.C. 1787(a)(1)(A).

§ 702.306 Revised business plans for new credit unions.

(a) *Schedule for filing.* (1) *Generally.* Except as provided in paragraph (a)(2) of this section, a new credit union classified "moderately capitalized" or lower must file a written revised business plan (RBP) with the appropriate Regional Director and, if State-chartered, with the appropriate State official, within 30 calendar days of either:

(i) The last of the calendar month following the end of the calendar quarter that the credit union's net worth ratio has not increased consistent with its the-present approved business plan;

(ii) The effective date of classification as less than "adequately capitalized" if the credit union has no then-present approved business plan; or

(iii) The effective date of classification as less than "adequately capitalized" if the credit union has increased the total amount of member business loans in violation of § 702.304(a)(3).

(2) *Exception.* The NCUA Board may notify the credit union in writing that its RBP is to be filed within a different period or that it is not necessary to file an RBP.

(3) *Failure to timely file plan.* When a new credit union fails to file an RBP as provided under paragraphs (a)(1) or (a)(2) of this section, the NCUA Board shall promptly notify the credit union that it has failed to file an RBP and that it has 15 calendar days from receipt of that notice within which to do so.

(b) *Contents of revised business plan.* A new credit union's RBP must, at a minimum—

(1) Address changes, since the new credit union's current business plan was approved, in any of the business plan elements required for charter approval under Chapter 1, section IV.D. of NCUA's *Chartering and Field of Membership Manual* (IRPS 99–1), 63 FR 71998, 72019 (Dec. 30, 1998), or its successor(s), or for State-chartered credit unions under applicable State law;

(2) Establish a timetable of quarterly targets for net worth during each year in which the

RBP is in effect so that the credit union becomes "adequately capitalized" by the time it no longer qualifies as "new" per § 702.301(b);

(3) Specify the projected amount of earnings to be transferred quarterly to its regular reserve as provided under § 702.304(a)(1) or 702.305(a)(1);

(4) Explain how the new credit union will comply with the mandatory and discretionary supervisory actions imposed on it by the NCUA Board under this subpart;

(5) Specify the types and levels of activities in which the new credit union will engage;

(6) In the case of a new credit union reclassified to a lower category under § 702.302(d), specify the steps the credit union will take to correct the unsafe or unsound condition or practice; and

(7) Include such other information as the NCUA Board may require.

(c) *Criteria for approval.* The NCUA Board shall not approve a new credit union's RBP unless it—

(1) Addresses the items enumerated in paragraph (b) of this section;

(2) Is based on realistic assumptions, and is likely to succeed in building the credit union's net worth; and

(3) Would not unreasonably increase the credit union's exposure to risk (including credit risk, interest-rate risk, and other types of risk).

(d) *Consideration of regulatory capital.* To minimize possible long-term losses to the NCUSIF while the credit union takes steps to become "adequately capitalized," the NCUA Board shall, in evaluating an RBP under this section, consider the type and amount of any form of regulatory capital which may become established by NCUA regulation, or authorized by State law and recognized by NCUA, which the credit union holds, but which is not included in its net worth.

(e) *Review of revised business plan*— (1) *Notice of decision.* Within 30 calendar days after receiving an RBP under this section, the NCUA Board shall notify the credit union in writing whether its RBP is approved, and shall provide reasons for its decision in the event of disapproval. The NCUA Board may extend the time within which notice of its decision shall be provided.

(2) *Delayed decision.* If no decision is made within the time prescribed in paragraph (e)(1) of this section, the RBP is deemed approved.

(3) *Consultation with State officials.* When evaluating an RBP submitted by a federally-insured State-chartered new credit union (whether an original, new or additional RBP), the NCUA Board shall seek and consider the views of the appropriate State official, and provide prompt notice of its decision to the appropriate State official.

(f) *Plan not approved*—(1) *Submission of new revised plan.* If an RBP is rejected by the NCUA Board, the new credit union shall submit a new RBP within 30 calendar days of receiving notice of disapproval of its initial RBP, unless it is notified in writing by the NCUA Board that the new RBP is to be filed within a different period.

(2) *Notice of decision on revised plan.* Within 30 calendar days after receiving an RBP under paragraph (f)(1) of this section, the NCUA Board shall notify the credit union in writing whether the new RBP is approved. The Board may extend the time within which notice of its decision shall be provided.

(g) *Amendment of plan.* A credit union that has filed an approved RBP may, after prior written notice to and approval by the NCUA Board, amend it to reflect a change in circumstance. Pending approval of an amended RBP, the new credit union shall implement its existing RBP as originally approved.

(h) *Publication.* An RBP need not be published to be enforceable because publication would be contrary to the public interest.

§ 702.307 Incentives for new credit unions.

(a) *Assistance in revising business plans.* Upon timely request by a credit union having total assets of less than $10 million (regardless how long it has been in operation), the NCUA Board shall provide assistance in preparing a revised business plan required to be filed under § 702.306.

(b) *Assistance.* Management training and other assistance to new credit unions will be provided in accordance with policies approved by the NCUA Board.

(c) *Small credit union program.* A new credit union is eligible to join and receive comprehensive benefits and assistance under NCUA's Small Credit Union Program.

Subpart D—Reserves

§ 702.401 Reserves.

(a) *Special reserve.* Each federally-insured credit union shall establish and maintain such reserves as may be required by the FCUA, by state law,

by regulation, or in special cases by the NCUA Board or appropriate State official.

(b) *Regular reserve.* Each federally-insured credit union shall establish and maintain a regular reserve account for the purpose of absorbing losses that exceed undivided earnings and other appropriations of undivided earnings, subject to paragraph (c) of this section. Earnings required to be transferred annually to a credit union's regular reserve under subparts B or C of this part shall be held in this account.

(c) *Charges to regular reserve after depleting undivided earnings.* The board of directors of a federally-insured credit union may authorize losses to be charged to the regular reserve after first depleting the balance of the undivided earnings account and other reserves, provided that the authorization states the amount and provides an explanation of the need for the charge, and either—

(1) The charge will not cause the credit union's net worth classification to fall below "adequately capitalized" under subparts B or C of this part; or

(2) If the charge will cause the net worth classification to fall below "adequately capitalized," the appropriate Regional Director and, if State-chartered, the appropriate State official, have given written approval (in an NWRP or otherwise) for the charge.

(d) *Transfers to regular reserve.* The transfer of earnings to a federally-insured credit union's regular reserve account when required under subparts B or C of this part must occur after charges for loan or other losses are addressed as provided in paragraph (c) of this section and § 702.402(d), but before payment of any dividends to members.

§ 702.402 Full and fair disclosure of financial condition.

(a) *Full and fair disclosure defined.* "Full and fair disclosure" is the level of disclosure which a prudent person would provide to a member of a federally-insured credit union, to NCUA, or, at the discretion of the board of directors, to creditors to fairly inform them of the financial condition and the results of operations of the credit union.

(b) *Full and fair disclosure implemented.* The financial statements of a federally-insured credit union shall provide for full and fair disclosure of all assets, liabilities, and members' equity, including such valuation (allowance) accounts as may be necessary to present fairly the financial condition; and all income and expenses necessary to present fairly the statement of income for the reporting period.

(c) *Declaration of officials.* The Statement of Financial Condition, when presented to members, to creditors or to the NCUA, shall contain a dual declaration by the treasurer and the chief executive officer, or in the latter's absence, by any other officer designated by the board of directors of the reporting credit union to make such declaration, that the report and related financial statements are true and correct to the best of their knowledge and belief and present fairly the financial condition and the statement of income for the period covered.

(d) *Charges for loan losses.* Full and fair disclosure demands that a credit union properly address charges for loan losses as follows:

(1) Charges for loan losses shall be made in accordance with generally accepted accounting principles (GAAP);

(2) The allowance for loan and lease losses (ALL) established for loans must fairly present the probable losses for all categories of loans and the proper valuation of loans. The valuation allowance must encompass specifically identified loans, as well as estimated losses inherent in the loan portfolio, such as loans and pools of loans for which losses have been incurred but are not identifiable on a specific loan-by-loan basis;

(3) Adjustments to the valuation ALL will be recorded in the expense account "Provision for Loan and Lease Losses";

(4) The maintenance of an ALL shall not affect the requirement to transfer earnings to a credit union's regular reserve when required under subparts B or C of this part; and

(5) At a minimum, adjustments to the ALL shall be made prior to the distribution or posting of any dividend to the accounts of members.

§ 702.403 Payment of dividends.

(a) *Restriction on dividends.* Dividends shall be available only from undivided earnings, if any.

(b) *Payment of dividends if undivided earnings depleted.* The board of directors of a "well capitalized" federally-insured credit union that has depleted the balance of its undivided earnings account may authorize a transfer of funds from the credit union's regular reserve account to undivided earnings to pay dividends, provided that either—

(1) The payment of dividends will not cause the credit union's net worth classification to fall below "adequately capitalized" under subpart B or C of this part; or

(2) If the payment of dividends will cause the net worth classification to fall below "adequately capitalized," the appropriate Regional Director and, if State-chartered, the appropriate State official, have given prior written approval (in an NWRP or otherwise) to pay a dividend.

tion provider, financial data, and tests and reports required by your investment policy and this part.

§ 703.50 What rules govern my dealings with entities I use to purchase and sell investments ("broker-dealers")?

(a) Except as provided in paragraph (c) of this section, you (a federal credit union) may use a third-party entity to purchase and sell investments (a "broker-dealer") as long as the broker-dealer either is registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) or is a depository institution whose broker-dealer activities are regulated by a federal regulatory agency.

(b) In determining whether to buy or sell investments through a broker-dealer, you must analyze and annually update the following factors:

(1) The background of any sales representative with whom you are doing business.

(2) Information available from state or federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers and the North American Securities Administrators Association, about any enforcement actions against the broker-dealer, its affiliates, or associated personnel.

(3) If the broker-dealer is acting as your counterparty, the ability of the broker-dealer and its subsidiaries or affiliates to fulfill commitments, as evidenced by capital strength, liquidity, and operating results. You should consider current financial data, annual reports, reports of nationally recognized statistical rating agencies, relevant disclosure documents, and other sources of financial information.

(c) The requirements of paragraph (a) of this section do not apply when you purchase a certificate of deposit or share certificate directly from a bank, credit union, or other depository institution.

§ 703.60 What rules govern my safekeeping of investments?

(a) Your (a federal credit union's) purchased investments and repurchase collateral must be in your possession, recorded as owned by you through the Federal Reserve Book-Entry System, or held by a board-approved safekeeper under a written custodial agreement. A custodial agreement is a contract in which a third party agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.

(b) You must obtain an individual confirmation statement for each investment purchased or sold.

(c) Any safekeeper you use must be regulated and supervised by either the Securities and Exchange Commission or a federal or state depository institution regulatory agency.

(d) You must obtain and reconcile monthly a statement of purchased investments and repurchase collateral held in safekeeping.

(e) All purchases and sales of investments must be delivery versus payment (*i.e.*, payment for an investment must occur simultaneously with its delivery).

§ 703.70 What must I do to monitor my non-security investments in banks, credit unions, and other depository institutions?

(a) At least quarterly you (a federal credit union) must prepare a written report listing all of your shares and deposits in banks, credit unions, and other depository institutions, that have one or more of the following features:

(1) Embedded options;

(2) Remaining maturities greater than 3 years; or

(3) Coupon formulas that are related to more than one index or are inversely related to, or multiples of, an index.

(b) The requirement described in paragraph (a) of this section does not apply to your shares and deposits that are securities.

(c) Where you do not have an investment-related committee, each member of your board of directors must receive a copy of the report described in paragraph (a) of this section. Where you have an investment-related committee, each member of the committee must receive a copy of the report, and each member of the board must receive a summary of the information in the report.

§ 703.80 What must I do to value my securities?

(a) Prior to purchasing or selling a security, except for new issues purchased at par or at original

issue discount, you (a federal credit union) must obtain, either:

(1) Price quotations on the security from at least two broker-dealers; or

(2) A price quotation on the security from an industry-recognized information provider.

(b) At least monthly, you must determine the fair value of each security you hold. You may determine fair value by obtaining a price quotation on the security from an industry-recognized information provider, a broker-dealer, or a safekeeper.

(c) At least annually, your supervisory committee (itself or through its external auditor) must independently assess the reliability of monthly price quotations you receive from a broker-dealer or safekeeper. Your supervisory committee (or external auditor) must follow Generally Accepted Auditing Standards, which require either recomputation or reference to market quotations.

(d) Where you are unable to obtain a price quotation required by this section for the precise security in question, you may obtain a quotation for a security with substantially similar characteristics.

§ 703.90 What must I do to monitor the risk of my securities?

(a) At least monthly, you (a federal credit union) must prepare a written report setting forth, for each security you hold, the fair value and dollar change since the prior month-end, with summary information for the entire portfolio.

(b) At least quarterly, you must prepare a written report setting forth the sum of the fair values of all fixed and variable rate securities you hold that have one or more of the following features:

(1) Embedded options;

(2) Remaining maturities greater than 3 years; or

(3) Coupon formulas that are related to more than one index or are inversely related to, or multiples of, an index.

(c) Where the amount calculated in paragraph (b) of this section is greater than your net capital, the report described in that paragraph must provide a reasonable and supportable estimate of the potential impact, in percentage and dollar terms, of an immediate and sustained parallel shift in market interest rates of plus and minus 300 basis points on:

(1) The fair value of each security in your portfolio;

(2) The fair value of your portfolio as a whole; and

(3) Your net capital.

(d) Where you do not have an investment-related committee, each member of your board of directors must receive a copy of the reports described in paragraphs (a) through (c) of this section. Where you have an investment-related committee, each member of the committee must receive copies of the reports, and each member of the board must receive a summary of the information in the reports.

§ 703.100 What investments and investment activities are permissible for me?

(a) You (a federal credit union) may contract for the purchase or sale of a security as long as the delivery of the security is by regular-way settlement. Regular-way settlement means delivery of a security from a seller to a buyer within the time frame that the securities industry has established for that type of security.

(b) You may invest in a variable rate investment, as long as the index is tied to domestic interest rates and not, for example, to foreign currencies, foreign interest rates, or domestic or foreign commodity prices, equity prices, or inflation rates. For purposes of this part, the U.S. dollar-denominated London Interbank Offered Rate (LIBOR) is a domestic interest rate.

(c) You may purchase shares or deposits in a corporate credit union, except where the NCUA Board has notified you that the corporate credit union is not operating in compliance with part 704 of this chapter. Your aggregate amount of paid-in capital and membership capital in one corporate credit union is limited to two percent of your assets measured at the time of investment or adjustment. Your aggregate amount of paid-in capital and membership capital in all corporate credit unions is limited to four percent of your assets measured at the time of investment or adjustment. Paid-in capital and membership capital are defined in part 704 of this chapter.

(d) You may invest in a registered investment company or collective investment fund, as long as the prospectus of the company or fund restricts the investment portfolio to investments and investment transactions that are permissible for federal credit unions. For the purposes of this part, the following definitions apply:

(1) A *registered investment company* is an investment company that is registered with the

Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a). Examples of registered investment companies are mutual funds and unit investment trusts.

(2) A *collective investment fund* is a fund maintained by a national bank under 12 CFR part 9.

(e) You may invest in fixed or variable rate CMOs/REMICs.

(f) You may purchase and hold a municipal security only if a nationally recognized statistical rating organization (NRSRO) has rated it in one of the four highest rating categories. A municipal security is a security as defined in Section 107(7)(K) of the Act. An NRSRO is a rating organization that the Securities and Exchange Commission has recognized as an NRSRO.

(g) You may sell federal funds to Section 107(8) institutions and credit unions, as long as the interest or other consideration received from the financial institution is at the market rate for federal funds transactions.

(h) You may invest in the following instruments issued by a Section 107(8) institution or branch:

(1) Yankee dollar deposits;

(2) Eurodollar deposits;

(3) Banker's acceptances;

(4) Deposit notes; and

(5) Bank notes with original weighted average maturities of less than five years.

(i) A repurchase transaction is a transaction in which you agree to purchase a security from a counterparty and to resell the same or an identical security to that counterparty at a specified future date and at a specified price. You may enter into a repurchase transaction as long as:

(1) The repurchase securities are legal investments for federal credit unions;

(2) You receive a daily assessment of the market value of the repurchase securities, including accrued interest, and maintain adequate margin that reflects a risk assessment of the repurchase securities and the term of the transaction; and

(3) You have entered into signed contracts with all approved counterparties.

(j) A reverse repurchase transaction is a transaction in which you agree to sell a security to a counterparty and to repurchase the same or an identical security from that counterparty at a specified future date and at a specified price. You may enter into reverse repurchase and collateralized borrowing transactions as long as:

(1) Any securities you receive are permissible investments for federal credit unions, you receive a daily assessment of their market value, including accrued interest, and you maintain adequate margin that reflects a risk assessment of the securities and the term of the transaction;

(2) Any cash you receive is subject to the borrowing limit specified in Section 107(9) of the Act, and any investments you purchase with that cash are permissible for federal credit unions and mature no later than the maturity of the transaction; and

(3) You have entered into signed contracts with all approved counterparties.

(k) You may enter into a securities lending transaction as long as:

(1) You receive written confirmation of the loan;

(2) Any collateral you receive is a legal investment for federal credit unions, you obtain a perfected first priority security interest in the collateral, you either take physical possession or control of the collateral or are recorded as owner of the collateral through the Federal Reserve Book-Entry Securities Transfer System; and you receive a daily assessment of the market value of the collateral, including accrued interest, and maintain adequate margin that reflects a risk assessment of the collateral and the term of the loan;

(3) Any cash you receive is subject to the borrowing limit specified in Section 107(9) of the Act, and any investments you purchase with that cash are permissible for federal credit unions and mature no later than the maturity of the transaction; and

(4) You have executed a written loan and security agreement with the borrower.

(l)(1) You may trade securities, including engaging in when-issued trading and pair-off transactions, as long as you can show that you have sufficient resources, knowledge, systems, and procedures to handle the risks.

(2) You must record any security you purchase or sell for trading purposes at fair value on the trade date. The trade date is the date you commit, orally or in writing, to purchase or sell a security.

(3) At least monthly, you must give your board of directors or investment-related committee a written report listing all purchase and sale transactions of trading securities and the resulting gain or loss on an individual basis.

§ 703.110 What investments and investment activities are prohibited for me?

(a) You (a federal credit union) may not purchase or sell financial derivatives, such as futures, options, interest rate swaps, or forward rate agreements, except as permitted under § 701.21(i) of this chapter.

(b) You may not engage in adjusted trading or short sales.

(c) You may not purchase stripped mortgage backed securities, residual interests in CMOs/REMICs, mortgage servicing rights, commercial mortgage related securities, or small business related securities.

(d) You may not purchase a zero coupon investment with a maturity date that is more than 10 years from the settlement date.

§ 703.120 May my officials or employees accept anything of value in connection with an investment transaction?

(a) Your (a federal credit union's) officials and senior management employees, and their immediate family members, may not receive anything of value in connection with your investment transactions. This prohibition also applies to any other employee, such as an investment officer, if the employee is directly involved in investments, unless your board of directors determines that the employee's involvement does not present a conflict of interest. This prohibition does not include compensation for employees.

(b) Your officials and employees must conduct all transactions with business associates or family members that are not specifically prohibited by paragraph (a) of this section at arm's length and in your best interest.

(c) Senior management employee means your chief executive officer (typically this individual holds the title of President or Treasurer/Manager), any assistant chief executive officers (e.g., Assistant President, Vice President, or Assistant Treasurer/Manager) and the chief financial officer (Comptroller).

(d) Immediate family member means a spouse or other family member living in the same household.

§ 703.130 May I continue to hold investments purchased before January 1, 1998, that will be impermissible after that date?

(a) Subject to safety and soundness considerations, you may hold a CMO/REMIC residual, SMBS, or zero coupon security with a maturity greater than 10 years, if you purchased the investment:

(1) Before December 2, 1991; or

(2) On or after December 2, 1991, but before January 1, 1998, if for the purpose of reducing interest rate risk and you meet the following:

(i) You have a monitoring and reporting system in place that provides the documentation necessary to evaluate the expected and actual performance of the investment under different interest rate scenarios;

(ii) You use the monitoring and reporting system to conduct and document an analysis that shows, before purchase, that the proposed investment will reduce your interest rate risk;

(iii) After purchase, you evaluate the investment at least quarterly to determine whether or not it actually has reduced your interest rate risk; and

(iv) You classify the investment as either trading or available-for-sale.

(b) All grandfathered investments are subject to the valuation and monitoring requirements of §§ 703.70, 703.80, and 703.90.

§ 703.140 What is the investment pilot program and how can I participate in it?

(a) Under the investment pilot program, NCUA will permit a limited number of federal credit unions to engage in investment activities prohibited by this part but permitted by statute.

(b) Except as provided in paragraph (c) of this section, before you (a federal credit union) may engage in additional activities, you must obtain written approval from NCUA. To begin the approval process, you must submit a request to your

Part 704

Corporate Credit Unions

§ 704.1 Scope.

(a) This part establishes special rules for all federally insured corporate credit unions. Non federally insured corporate credit unions must agree, by written contract, to both adhere to the requirements of this part and submit to examinations, as determined by NCUA, as a condition of receiving shares or deposits from federally insured credit unions. This part grants certain additional authorities to federal corporate credit unions. Except to the extent that they are inconsistent with this part, other provisions of NCUA's Rules and Regulations (12 CFR chapter VII) and the Federal Credit Union Act apply to federally chartered corporate credit unions and federally insured state-chartered corporate credit unions to the same extent that they apply to other federally chartered and federally insured state-chartered credit unions, respectively.

(b) The Board has the authority to issue orders which vary from this part. This authority is provided under Section 120(a) of the Federal Credit Union Act, 12 U.S.C. 1766(a). Requests by state-chartered corporate credit unions for waivers to this part and for expansions of authority under Appendix B of this part must be approved by the state regulator before being submitted to NCUA.

§ 704.2 Definitions.

Adjusted trading means any method or transaction whereby a corporate credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from the vendor another security at a price above its current market price.

Asset-backed security (ABS) means a security that is primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the securityholders. This definition excludes mortgage related securities.

Capital means the sum of a corporate credit union's retained earnings, paid-in capital, and membership capital.

Capital ratio means the corporate credit union's capital divided by its moving daily average net assets.

Collateralized mortgage obligation (CMO) means a multi-class mortgage-related security.

Core capital means the corporate credit union's retained earnings and paid-in capital.

Core capital ratio means the corporate credit union's core capital divided by its moving daily average net assets.

Corporate credit union means an organization that:

(1) Is chartered under Federal or state law as a credit union;

(2) Receives shares from and provides loan services to credit unions;

(3) Is operated primarily for the purpose of serving other credit unions;

(4) Is designated by NCUA as a corporate credit union;

(5) Limits natural person members to the minimum required by state or federal law to charter and operate the credit union; and

(6) Does not condition the eligibility of any credit union to become a member on that credit union's membership in any other organization.

Daily average net assets means the average of net assets calculated for each day during the period.

Dollar roll means the purchase or sale of a mortgage backed security to a counterparty with an agreement to resell or repurchase a substantially identical security at a future date and at a specified price.

Embedded option means a characteristic of certain assets and liabilities which gives the issuer of the instrument the ability to change the features such as final maturity, rate, principal amount and average life. Options include, but are not limited to, calls, caps, and prepayment options.

Fair value means the amount at which an instrument could be exchanged in a current, arms-length transaction between willing parties, as opposed to a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value. If a quoted market price in an active

market is not available, fair value may be estimated using a valuation technique that is reasonable and supportable, a quoted market price in an active market for a similar instrument, or a current appraised value. Examples of valuation techniques include the present value of estimated future cash flows, option-pricing models, and option-adjusted spread models. Valuation techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility.

Federal funds transaction means a short-term or open-ended unsecured transfer of immediately available funds by one depository institution to another depository institution or entity.

Foreign bank means an institution which is organized under the laws of a country other than the United States, is engaged in the business of banking, and is recognized as a bank by the banking supervisory authority of the country in which it is organized.

Forward settlement of a transaction means settlement on a date later than regular-way settlement.

Immediate family member means a spouse or other family member living in the same household.

Limited liquidity investment means a private placement or funding agreement.

Member reverse repurchase transaction means an integrated transaction in which a corporate credit union purchases a security from one of its member credit unions under agreement by that member credit union to repurchase the same security at a specified time in the future. The corporate credit union then sells that same security, on the same day, to a third party, under agreement to repurchase it on the same date on which the corporate credit union is obligated to return the security to its member credit union.

Membership capital means funds contributed by members that: are adjustable balance with a minimum withdrawal notice of 3 years or are term certificates with a minimum term of 3 years; are available to cover losses that exceed retained earnings and paid-in capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

Mortgage related security means a security as defined in section 3(a)(41) of the Securities Exchange Act of 1934,15 U.S.C. 78c(a)(41), *e.g.*, a privately-issued security backed by mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure that is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization.

Moving daily average net assets means the average of daily average net assets for the month being measured and the previous 11 months.

NCUA means NCUA Board (Board), unless the particular action has been delegated by the Board.

Net assets means total assets less Central Liquidity Facility (CLF) stock subscriptions, CLF loans guaranteed by the NCUSIF, U.S. Central CLF certificates, and member reverse repurchase transactions. For its own account, a corporate credit union's payables under reverse repurchase agreements and receivables under repurchase agreements may be netted out if the Generally Accepted Accounting Principles (GAAP) conditions for offsetting are met.

Net economic value (NEV) means the fair value of assets minus the fair value of liabilities. All fair value calculations must include the value of forward settlements and embedded options. The amortized portion of membership capital and paid-in capital, which do not qualify as capital, are treated as liabilities for purposes of this calculation. The NEV ratio is calculated by dividing NEV by the fair value of assets.

Obligor means the primary party obligated to repay an investment, *e.g.*, the issuer of a security, the taker of a deposit, or the borrower of funds in a federal funds transaction. Obligor does not include an originator of receivables underlying an asset-backed security, the servicer of such receivables, or an insurer of an investment.

Official means any director or committee member.

Paid-in capital means accounts or other interests of a corporate credit union that: are perpetual, non-cumulative dividend accounts; are available to cover losses that exceed retained earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

Pair-off transaction means a security purchase transaction that is closed out or sold at, or prior to, the settlement or expiration date.

Quoted market price means a recent sales price or a price based on current bid and asked quotations.

Regular-way settlement means delivery of a security from a seller to a buyer within the time frame that the securities industry has established for immediate delivery of that type of security. For example, regular-way settlement of a Treas-

ury security includes settlement on the trade date ("cash"), the business day following the trade date ("regular way"), and the second business day following the trade date ("skip day").

Repurchase transaction means a transaction in which a corporate credit union agrees to purchase a security from a counterparty and to resell the same or any identical security to that counterparty at a specified future date and at a specified price.

Residual interest means the remainder cash flows from a CMO or ABS transaction after payments due bondholders and trust administrative expenses have been satisfied.

Retained earnings means the total of the corporate credit union's undivided earnings, reserves, and any other appropriations designated by management or regulatory authorities. For purposes of this regulation, retained earnings does not include the allowance for loan and lease losses account, accumulated unrealized gains and losses on available for sale securities, or other comprehensive income items.

Retained earnings ratio means the corporate credit union's retained earnings divided by its moving daily average net assets.

Section 107(8) institution means an institution described in Section 107(8) of the Federal Credit Union Act (12 U.S.C. 1757(8)).

Securities lending means lending a security to a counterparty, either directly or through an agent, and accepting collateral in return.

Senior management employee means a chief executive officer, any assistant chief executive officer (e.g., any assistant president, any vice president or any assistant treasurer/manager), and the chief financial officer (controller).

Settlement date means the date originally agreed to by a corporate credit union and a counterparty for settlement of the purchase or sale of a security.

Short sale means the sale of a security not owned by the seller.

Small business related security means a security as defined in Section 3(a)(53) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(53)), i.e., a security, rated in one of the four highest rating categories by a nationally recognized statistical rating organization, that represents ownership of one or more promissory notes or leases of personal property which evidence the obligation of a small business concern. It does not mean a security issued or guaranteed by the Small Business Administration.

Stripped mortgage-backed security means a security that represents either the principal or interest only portion of the cash flows of an underlying pool of mortgages.

Trade date means the date a corporate credit union originally agrees, whether orally or in writing, to enter into the purchase or sale of a security.

Weighted average life means the weighted average time to principal repayment of a security based upon the proportional balances of the cash flows that make up the security.

When-issued trading means the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities.

Wholesale corporate credit union means a corporate credit union which primarily serves other corporate credit unions.

§ 704.3 Corporate credit union capital.

(a) *Capital plan.* A corporate credit union must develop and ensure implementation of written short- and long-term capital goals, objectives, and strategies which provide for the building of capital consistent with regulatory requirements, the maintenance of sufficient capital to support the risk exposures that may arise from current and projected activities, and the periodic review and reassessment of the capital position of the corporate credit union.

(b) *Requirements for membership capital*—(1) *Form.* Membership capital funds may be in the form of a term certificate or an adjusted balance account.

(2) *Disclosure.* The terms and conditions of a membership capital account must be disclosed to the recorded owner of the account at the time the account is opened and at least annually thereafter.

(i) The initial disclosure must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board; and

(ii) The annual disclosure notice must be signed by the chair of the corporate credit union. The chair must sign a statement that certifies that the notice has been sent to member credit unions with membership capital accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

(3) *Three-year remaining maturity.* When a membership capital account has been placed on notice or has a remaining maturity of less than

three years, the amount of the account that can be considered membership capital is reduced by a constant monthly amortization that ensures membership capital is fully amortized one year before the date of maturity or one year before the end of the notice period. The full balance of a membership capital account being amortized, not just the remaining non-amortized portion, is available to absorb losses in excess of the sum of retained earnings and paid-in capital until the funds are released by the corporate credit union at the time of maturity or the conclusion of the notice period.

(4) *Release.* Membership capital may not be released due solely to the merger, charter conversion or liquidation of a member credit union. In the event of a merger, the membership capital transfers to the continuing credit union. In the event of a charter conversion, the membership capital transfers to the new institution. In the event of liquidation, the membership capital may be released to facilitate the payout of shares with the prior written approval of the OCCU Director.

(5) *Sale.* A member may sell its membership capital to another member in the corporate credit union's field of membership, subject to the corporate credit union's approval.

(6) *Liquidation.* In the event of liquidation of a corporate credit union, membership capital is payable only after satisfaction of all liabilities of the liquidation estate, including uninsured share obligations to shareholders and the National Credit Union Share Insurance Fund (NCUSIF), but excluding paid-in capital.

(7) *Merger.* In the event of a merger of a corporate credit union, membership capital transfers to the continuing corporate credit union. The minimum three-year notice period for withdrawal of membership capital remains in effect.

(8) *Adjusted balance accounts:*

(i) May be adjusted no more frequently than once every six months; and

(ii) Must be adjusted in relation to a measure, *e.g.*, one percent of a member credit union's assets, established and disclosed at the time the account is opened without regard to any minimum withdrawal period. If the measure is other than assets, the corporate credit union must address the measure's permanency characteristics in its capital plan.

(iii) *Notice of withdrawal.* Upon written notice of intent to withdraw membership capital, the balance of the account will be frozen (no further adjustments) until the conclusion of the notice period.

(9) *Grandfathering.* Membership capital issued before the effective date of this regulation is exempt from the limitation of § 704.3(b)(8)(i).

(c) *Requirements for paid-in capital*—(1) *Disclosure.* The terms and conditions of any paid-in capital instrument must be disclosed to the recorded owner of the instrument at the time the instrument is created and must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board.

(2) *Release.* Paid-in capital may not be released due solely to the merger, charter conversion or liquidation of a member credit union. In the event of a merger, the paid-in capital transfers to the continuing credit union. In the event of a charter conversion, the paid-in capital transfers to the new institution. In the event of liquidation, the paid-in capital may be released to facilitate the payout of shares with the prior written approval of the OCCU Director.

(3) *Callability.* Paid-in capital accounts are callable on a pro-rata basis across an issuance class only at the option of the corporate credit union and only if the corporate credit union meets its minimum level of required capital and NEV ratios after the funds are called.

(4) *Liquidation.* In the event of liquidation of the corporate credit union, paid-in capital is payable only after satisfaction of all liabilities of the liquidation estate, including uninsured share obligations to shareholders, the NCUSIF, and membership capital holders.

(5) *Merger.* In the event of a merger of a corporate credit union, paid-in capital shall transfer to the continuing corporate credit union.

(6) *Paid-in capital.* Paid-in capital includes both member and nonmember paid-in capital.

(i) Member paid-in capital means paid-in capital that is held by the corporate credit union's members. A corporate credit union may not condition membership, services, or prices for services on a credit union's ownership of paid-in capital.

(ii) Nonmember paid-in capital means paid-in capital that is not held by the corporate credit union's members.

(7) *Grandfathering.* A corporate credit union's authority to include paid-in capital as a component of capital is governed by the regula-

tion in effect at the time the paid-in capital was issued. When a grandfathered paid-in capital instrument has a remaining maturity of less than 3 years, the amount that may be considered paid-in capital is reduced by a constant monthly amortization that ensures the paid-in capital is fully amortized 1 year before the date of maturity. The full balance of grandfathered paid-in capital being amortized, not just the remaining non-amortized portion, is available to absorb losses in excess of retained earnings until the funds are released by the corporate credit union at maturity.

(d) *Capital ratio.* A corporate credit union will maintain a minimum capital ratio of 4 percent, except as otherwise provided in this part. A corporate credit union must calculate its capital ratio at least monthly.

(e) *Individual capital ratio requirement*—(1) When significant circumstances or events warrant, the OCCU Director may require a different minimum capital ratio for an individual corporate credit union based on its circumstances. Factors that may warrant a different minimum capital ratio include, but are not limited to:

(i) An expectation that the corporate credit union has or anticipates losses resulting in capital inadequacy;

(ii) Significant exposure exists, unsupported by adequate capital or risk management processes, due to credit, liquidity, market, fiduciary, operational, and similar types of risks;

(iii) A merger has been approved; or

(iv) An emergency exists because of a natural disaster.

(2) When the OCCU Director determines that a different minimum capital ratio is necessary or appropriate for a particular corporate credit union, he or she will notify the corporate credit union in writing of the proposed capital ratio and the date by which the capital ratio must be reached. The OCCU Director also will provide an explanation of why the proposed capital ratio is considered necessary or appropriate.

(3)(i) The corporate credit union may respond to any or all of the items in the notice. The response must be in writing and delivered to the OCCU Director within 30 calendar days after the date on which the corporate credit union received the notice. The OCCU Director may shorten the time period when, in its opinion, the condition of the corporate credit union so requires, provided that the corporate credit union is informed promptly of the new time period, or with the consent of the corporate credit union. In its discretion, the OCCU Director may extend the time period for good cause.

(ii) Failure to respond within 30 calendar days or such other time period as may be specified by the OCCU Director shall constitute a waiver of any objections to any item in the notice. Failure to address any item in a response shall constitute a waiver of any objection to that item.

(iii) After the close of the corporate credit union's response period, the OCCU Director will decide, based on a review of the corporate credit union's response and other information concerning the corporate credit union, whether a different minimum capital ratio should be established for the corporate credit union and, if so, the capital ratio and the date the requirement must be reached. The corporate credit union will be notified of the decision in writing. The notice will include an explanation of the decision, except for a decision not to establish a different minimum capital ratio for the corporate credit union.

(f) *Failure to maintain minimum capital ratio requirement.* When a corporate credit union's capital ratio falls below the minimum required by paragraphs (d) or (e) of this section, or Appendix B to this part, as applicable, operating management of the corporate credit union must notify its board of directors, supervisory committee, and the OCCU Director within 10 calendar days.

(g) *Capital restoration plan.* (1) A corporate credit union must submit a plan to restore and maintain its capital ratio at the minimum requirement when either of the following conditions exist:

(i) The capital ratio falls below the minimum requirement and is not restored to the minimum requirement by the next month end; or

(ii) Regardless of whether the capital ratio is restored by the next month end, the capital ratio falls below the minimum requirement for three months in any 12-month period.

(2) The capital restoration plan must, at a minimum, include the following:

(i) Reasons why the capital ratio fell below the minimum requirement;

(ii) Descriptions of steps to be taken to restore the capital ratio to the minimum requirement within specific time frames;

(iii) Actions to be taken to maintain the capital ratio at the minimum required level and increase it thereafter;

(iv) Balance sheet and income projections, including assumptions, for the current calendar year and one additional calendar year; and

(v) Certification from the board of directors that it will follow the proposed plan if approved by the OCCU Director.

(3) The capital restoration plan must be submitted to the OCCU Director within 30 calendar days of the occurrence. The OCCU Director will respond to the corporate credit union regarding the adequacy of the plan within 45 calendar days of its receipt.

(h) *Capital directive.* (1) If a corporate credit union fails to submit a capital restoration plan; or the plan submitted is not deemed adequate to either restore capital or restore capital within a reasonable time; or the credit union fails to implement its approved capital restoration plan, NCUA may issue a capital directive.

(2) A capital directive may order a corporate credit union to:

(i) Achieve adequate capitalization within a specified time frame by taking any action deemed necessary, including but not limited to the following:

(A) Increase the amount of capital to specific levels;

(B) Reduce dividends;

(C) Limit receipt of deposits to those made to existing accounts;

(D) Cease or limit issuance of new accounts or any or all classes of accounts;

(E) Cease or limit lending or making a particular type or category of loans;

(F) Cease or limit the purchase of specified investments;

(G) Limit operational expenditures to specified levels;

(H) Increase and maintain liquid assets at specified levels; and

(I) Restrict or suspend expanded authorities issued under Appendix B of this part.

(ii) Adhere to a previously submitted plan to achieve adequate capitalization.

(iii) Submit and adhere to a capital plan acceptable to NCUA describing the means and a time schedule by which the corporate credit union shall achieve adequate capitalization.

(iv) Meet with NCUA.

(v) Take a combination of these actions.

(3) Prior to issuing a capital directive, NCUA will notify a corporate credit union in writing of its intention to issue a capital directive.

(i) The notice will state:

(A) The reasons for the issuance of the directive; and

(B) The proposed content of the directive.

(ii) A corporate credit union must respond in writing within 30 calendar days of receipt of the notice stating that it either concurs or disagrees with the notice. If it disagrees with the notice, it must state the reasons why the directive should not be issued and/or propose alternative contents for the directive. The response should include all matters that the corporate credit union wishes to be considered. For good cause, including the following conditions, the response time may be shortened or lengthened:

(A) When the condition of the corporate requires, and the corporate credit union is notified of the shortened response period in the notice;

(B) With the consent of the corporate credit union; or

(C) When the corporate credit union already has advised NCUA that it cannot or will not achieve adequate capitalization.

(iii) Failure to respond within 30 calendar days, or another time period specified in the notice, shall constitute a waiver of any objections to the proposed directive.

(4) After the closing date of the corporate credit union's response period, or the receipt of the response, if earlier, NCUA shall consider the response and may seek additional information or clarification. Based on the information provided during the response period, NCUA will determine whether or not to issue a capital directive and, if issued, the form it should take.

(5) Upon issuance, a capital directive and a statement of the reasons for its issuance will be delivered to the corporate credit union. A directive is effective immediately upon receipt by the corporate credit union, or upon such later date as may be specified therein, and shall remain effective and enforceable until it is stayed, modified, or terminated by NCUA.

(6) A capital directive may be issued in addition to, or in lieu of, any other action authorized by law in response to a corporate credit union's failure to achieve or maintain the applicable minimum capital ratios.

(7) Upon a change in circumstances, a corporate credit union may request reconsideration of the terms of the directive. Requests that are not based on a significant change in circumstances or are repetitive or frivolous will not be considered. Pending a decision on reconsideration, the directive shall continue in full force and effect.

(i) *Earnings retention requirement.* A corporate credit union must increase retained earnings if the prior month-end retained earnings ratio is less than 2 percent.

(1) Its retained earnings must increase:

(i) During the current month, by an amount equal to or greater than the monthly earnings retention amount; or

(ii) During the current and prior two months, by an amount equal to or greater than the quarterly earnings retention amount.

(2) Earnings retention amounts are calculated as follows:

(i) The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month-end moving daily average net assets; and

(ii) The quarterly earnings retention amount is determined by multiplying the earnings retention factor by moving daily average net assets for each of the prior three month-ends.

(3) The earnings retention factor is determined as follows:

(i) If the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or

(ii) If the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is equal to or greater than 3 percent, the earnings retention factor is .10 percent per annum.

(4) The OCCU Director may approve a decrease to the earnings retention amount if it is determined a lesser amount is necessary to avoid a significant adverse impact upon a corporate credit union.

(5) Operating management of the corporate credit union must notify its board of directors, supervisory committee, the OCCU Director and, if applicable, the state regulator within 10 calendar days of determining that the retained earnings ratio has declined below 2 percent. If the decline in the retained earnings ratio is due, in full or in part, to a decline in the dollar amount of retained earnings and the retained earnings ratio is not restored to at least 2 percent by the next month end, a retained earnings action plan is required to be submitted within 30 calendar days.

(6) The retained earnings action plan must be submitted to the OCCU Director and, if applicable, the state regulator and, at a minimum, include the following:

(i) Reasons why the dollar amount of retained earnings has decreased;

(ii) Description of actions to be taken to increase the dollar amount of retained earnings within specific time frames; and

(iii) Monthly balance sheet and income projections, including assumptions, for the next 12-month period.

§ 704.4 Board responsibilities.

(a) *General.* A corporate credit union's board of directors must approve comprehensive written strategic plans and policies, review them annually, and provide them upon request to the auditors, supervisory committee, and NCUA.

(b) *Policies.* A corporate credit union's policies must be commensurate with the scope and complexity of the corporate credit union.

(c) *Other requirements.* The board of directors of a corporate credit union must ensure:

(1) Senior managers have an in-depth, working knowledge of their direct areas of responsibility and are capable of identifying, hiring, and retaining qualified staff;

(2) Qualified personnel are employed or under contract for all line support and audit areas, and designated back-up personnel or resources with adequate cross-training are in place;

(3) GAAP is followed, except where law or regulation has provided for a departure from GAAP;

(4) Accurate balance sheets, income statements, and internal risk assessments (*e.g.*, risk management measures of liquidity, market, and credit risk associated with current activities) are produced timely in accordance with §§ 704.6, 704.8, and 704.9;

(5) Systems are audited periodically in accordance with industry-established standards;

(6) Financial performance is evaluated to ensure that the objectives of the corporate credit union and the responsibilities of management are met; and

(7) Planning addresses the retention of external consultants, as appropriate, to review the adequacy of technical, human, and financial resources dedicated to support major risk areas.

§ 704.5 Investments.

(a) *Policies.* A corporate credit union must operate according to an investment policy that is con-

sistent with its other risk management policies, including, but not limited to, those related to credit risk management, asset and liability management, and liquidity management. The policy must address, at a minimum:

(1) Appropriate tests and criteria for evaluating investments and investment transactions before purchase; and

(2) Reasonable and supportable concentration limits for limited liquidity investments in relation to capital.

(b) *General.* All investments must be U.S. dollar-denominated and subject to the credit policy restrictions set forth in § 704.6.

(c) *Authorized activities.* A corporate credit union may invest in:

(1) Securities, deposits, and obligations set forth in Sections 107(7), 107(8), and 107(15) of the Federal Credit Union Act, 12 U.S.C. 1757(7), 1757(8), and 1757(15), except as provided in this section;

(2) Deposits in, the sale of federal funds to, and debt obligations of corporate credit unions, Section 107(8) institutions, and state banks, trust companies, and mutual savings banks not domiciled in the state in which the corporate credit union does business;

(3) Corporate CUSOs, as defined in and subject to the limitations of § 704.11;

(4) Marketable debt obligations of corporations chartered in the United States. This authority does not apply to debt obligations that are convertible into the stock of the corporation; and

(5) Domestically-issued asset-backed securities.

(d) *Repurchase agreements.* A corporate credit union may enter into a repurchase agreement provided that:

(1) The corporate credit union, directly or through its agent, receives written confirmation of the transaction, and either takes physical possession or control of the repurchase securities or is recorded as owner of the repurchase securities through the Federal Reserve Book-Entry Securities Transfer System;

(2) The repurchase securities are legal investments for that corporate credit union;

(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of the repurchase securities and maintains adequate margin that reflects a risk assessment of the repurchase securities and the term of the transaction; and

(4) The corporate credit union has entered into signed contracts with all approved counterparties and agents, and ensures compliance with the contracts. Such contracts must address any supplemental terms and conditions necessary to meet the specific requirements of this part. Third party arrangements must be supported by tri-party contracts in which the repurchase securities are priced and reported daily and the tri-party agent ensures compliance; and

(e) *Securities Lending.* A corporate credit union may enter into a securities lending transaction provided that:

(1) The corporate credit union, directly or through its agent, receives written confirmation of the loan, obtains a first priority security interest in the collateral by taking physical possession or control of the collateral, or is recorded as owner of the collateral through the Federal Reserve Book-Entry Securities Transfer System;

(2) The collateral is a legal investment for that corporate credit union;

(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of collateral and maintains adequate margin that reflects a risk assessment of the collateral and terms of the loan; and

(4) The corporate credit union has entered into signed contracts with all agents and, directly or through its agent, has executed a written loan and security agreement with the borrower. The corporate or its agent ensures compliance with the agreements.

(f) *Investment companies.* A corporate credit union may invest in an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a), provided that the prospectus of the company restricts the investment portfolio to investments and investment transactions that are permissible for that corporate credit union.

(g) *Forward settlement of transactions later than regular way.* A corporate credit union may enter into an agreement to purchase or sell an instrument, with settlement later than regular way, provided that:

(1) Delivery and acceptance are mandatory;

(2) The transaction is clearly disclosed in the appropriate risk reporting required under § 704.8(b);

(3) If the corporate credit union is the purchaser, it has adequate cash flow projections

evidencing its ability to purchase the instrument;

(4) If the corporate credit union is the seller, it owns the instrument on the trade date; and

(5) The transaction is settled on a cash basis at the settlement date.

(h) *Prohibitions.* A corporate credit union is prohibited from:

(1) Purchasing or selling off balance sheet financial derivatives, such as futures, options, interest rate swaps, or forward rate agreements;

(2) Engaging in trading securities unless accounted for on a trade date basis;

(3) Engaging in adjusted trading or short sales; and

(4) Purchasing stripped mortgage-backed securities, mortgage servicing rights, small business related securities, or residual interests in CMOs or asset-backed securities.

(i) *Conflicts of interest.* A corporate credit union's officials, employees, and immediate family members of such individuals, may not receive pecuniary consideration in connection with the making of an investment or deposit by the corporate credit union. Employee compensation is exempt from this prohibition. All transactions not specifically prohibited by this paragraph must be conducted at arm's length and in the interest of the corporate credit union.

(j) *Grandfathering.* A corporate credit union's authority to hold an investment is governed by the regulation in effect at the time of purchase. However, all grandfathered investments are subject to the requirements of §§ 704.8 and 704.9.

§ 704.6 Credit risk management.

(a) *Policies.* A corporate credit union must operate according to a credit risk management policy that is commensurate with the investment risks and activities it undertakes. The policy must address at a minimum:

(1) The approval process associated with credit limits;

(2) Due diligence analysis requirements;

(3) Maximum credit limits with each obligor and transaction counterparty, set as a percentage of capital. In addition to addressing deposits and securities, limits with transaction counterparties must address aggregate exposures of all transactions including, but not limited to, repurchase agreements, securities lending, and forward settlement of purchases or sales of investments; and

(4) Concentrations of credit risk (*e.g.*, originator of receivables, insurer, industry type, sector type, and geographic).

(b) *Exemption.* The requirements of this section do not apply to investments that are issued or fully guaranteed as to principal and interest by the U.S. government or its agencies or enterprises (excluding subordinated debt) or are fully insured (including accumulated interest) by the NCUSIF or Federal Deposit Insurance Corporation.

(c) *Concentration limits*—(1) *General rule.* The aggregate of all investments in any single obligor is limited to 50 percent of capital or $5 million, whichever is greater.

(2) *Exceptions.* Exceptions to the general rule are:

(i) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 200 percent of capital;

(ii) Investments in corporate CUSOs are subject to the limitations of § 704.11; and

(iii) Aggregate investments in corporate credit unions are not subject to the limitations of paragraph (c)(1) of this section.

(3) For purposes of measurement, each new credit transaction must be evaluated in terms of the corporate credit union's capital at the time of the transaction. An investment that fails a requirement of this section because of a subsequent reduction in capital will be deemed nonconforming. A corporate credit union is required to exercise reasonable efforts to bring nonconforming investments into conformity within 90 calendar days. Investments that remain nonconforming for 90 calendar days will be deemed to fail a requirement of this section and the corporate credit union will have to comply with § 704.10.

(d) *Credit ratings.*—(1) All investments, other than in a corporate credit union or CUSO, must have an applicable credit rating from at least one nationally recognized statistical rating organization (NRSRO).

(2) At the time of purchase, investments with long-term ratings must be rated no lower than AA– (or equivalent) and investments with short-term ratings must be rated no lower than A–1 (or equivalent).

(3) Any rating(s) relied upon to meet the requirements of this part must be identified at the time of purchase and must be monitored for as long as the corporate owns the investment.

(4) When two or more ratings are relied upon to meet the requirements of this part at

the time of purchase, the board or an appropriate committee must place on the § 704.6(e)(1) investment watch list any investment for which a rating is downgraded below the minimum rating requirements of this part.

(5) Investments are subject to the requirements of § 704.10 if:

(i) One rating was relied upon to meet the requirements of this part and that rating is downgraded below the minimum rating requirements of this part; or

(ii) Two or more ratings were relied upon to meet the requirements of this part and at least two of those ratings are downgraded below the minimum rating requirements of this part.

(e) *Reporting and documentation.* (1) At least annually, a written evaluation of each credit limit with each obligor or transaction counterparty must be prepared and formally approved by the board or an appropriate committee. At least monthly, the board or an appropriate committee must receive an investment watch list of existing and/or potential credit problems and summary credit exposure reports, which demonstrate compliance with the corporate credit union's risk management policies.

(2) At a minimum, the corporate credit union must maintain:

(i) A justification for each approved credit limit;

(ii) Disclosure documents, if any, for all instruments held in portfolio. Documents for an instrument that has been sold must be retained until completion of the next NCUA examination; and

(iii) The latest available financial reports, industry analyses, internal and external analyst evaluations, and rating agency information sufficient to support each approved credit limit.

§ 704.7 Lending.

(a) *Policies.* A corporate credit union must operate according to a lending policy which addresses, at a minimum:

(1) Loan types and limits;

(2) Required documentation and collateral; and

(3) Analysis and monitoring standards.

(b) *General.* Each loan or line of credit limit will be determined after analyzing the financial and operational soundness of the borrower and the ability of the borrower to repay the loan.

(c) *Loans to members*—(1) *Credit unions.* (i) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 50 percent of capital.

(ii) The maximum aggregate amount in secured loans and lines of credit to any one member credit union, excluding those secured by shares or marketable securities and member reverse repurchase transactions, must not exceed 100 percent of capital.

(2) *Corporate CUSOs.* Any loan or line of credit must comply with § 704.11.

(3) *Other members.* The maximum aggregate amount of loans and lines of credit to any other one member must not exceed 15 percent of the corporate credit union's capital plus pledged shares.

(d) *Loans to nonmembers*—(1) *Credit unions.* A loan to a nonmember credit union, other than through a loan participation with another corporate credit union, is only permissible if the loan is for an overdraft related to the providing of correspondent services pursuant to § 704.12. Generally, such a loan will have a maturity of one business day.

(2) *Corporate CUSOs.* Any loan or line of credit must comply with § 704.11.

(e) *Member business loan rule.* Loans, lines of credit and letters of credit to:

(1) Member credit unions are exempt from part 723 of this chapter;

(2) Corporate CUSOs must comply with § 704.11; and

(3) Other members not excluded under § 723.1(b) of this chapter must comply with part 723 of this chapter unless the loan or line of credit is fully guaranteed by a credit union or fully secured by U.S. Treasury or agency securities. Those guaranteed and secured loans must comply with the aggregate limits of § 723.16 but are exempt from the other requirements of part 723.

(f) *Participation loans with other corporate credit unions.* A corporate credit union is permitted to participate in a loan with another corporate credit union provided the corporate retains an interest of at least 5 percent of the face amount of the loan and a master participation loan agreement is in place before the purchase or the sale of a participation. A participating corporate credit union must exercise the same due diligence as if it were the originating corporate credit union.

(g) *Prepayment penalties.* If provided for in the loan contract, a corporate credit union is authorized to assess prepayment penalties on loans.

§ 704.8 Asset and liability management.

(a) *Policies.* A corporate credit union must operate according to a written asset and liability management policy which addresses, at a minimum:

(1) The purpose and objectives of the corporate credit union's asset and liability activities;

(2) The maximum allowable percentage decline in net economic value (NEV), compared to base case NEV;

(3) The minimum allowable NEV ratio;

(4) Policy limits and specific test parameters for the interest rate risk simulation tests set forth in paragraph (d) of this section; and

(5) The modeling of indexes that serve as references in financial instrument coupon formulas; and

(6) The tests that will be used, prior to purchase, to estimate the impact of investments on the percentage decline in NEV, compared to base case NEV. The most recent NEV analysis, as determined under paragraph (d)(1)(i) of this section may be used as a basis of estimation.

(b) *Asset and liability management committee (ALCO).* A corporate credit union's ALCO must have at least one member who is also a member of the board of directors. The ALCO must review asset and liability management reports on at least a monthly basis. These reports must address compliance with Federal Credit Union Act, NCUA Rules and Regulations (12 CFR chapter VII), and all related risk management policies.

(c) *Penalty for early withdrawals.* A corporate credit union that permits early certificate/share withdrawals must assess market-based penalties sufficient to cover the estimated replacement cost of the certificate/share redeemed. This means the minimum penalty must be reasonably related to the rate that the corporate credit union would be required to offer to attract funds for a similar term with similar characteristics.

(d) *Interest rate sensitivity analysis.* (1) A corporate credit union must:

(i) Evaluate the risk in its balance sheet by measuring, at least quarterly, the impact of an instantaneous, permanent, and parallel shock in the yield curve of plus and minus 100, 200, and 300 basis points on its NEV and NEV ratio. If the base case NEV ratio falls below 3 percent at the last testing date, these tests must be calculated at least monthly until the base case NEV ratio again exceeds 3 percent;

(ii) Limit its risk exposure to levels that do not result in a base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section below 2 percent; and

(iii) Limit its risk exposures to levels that do not result in a decline in NEV of more than 15 percent.

(2) A corporate credit union must assess annually if it should conduct periodic additional tests to address market factors that may materially impact that corporate credit union's NEV. These factors should include, but are not limited to, the following:

(i) Changes in the shape of the Treasury yield curve;

(ii) Adjustments to prepayment projections used for amortizing securities to consider the impact of significantly faster/slower prepayment speeds;

(iii) Adjustments to the market spread assumptions for non Treasury instruments to consider the impact of widening spreads; and

(iv) Adjustments to volatility assumptions to consider the impact that changing volatilities have on embedded option values.

(e) *Regulatory violations.* If a corporate credit union's decline in NEV, base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section violates the limits established by this rule and is not brought into compliance within 10 calendar days, operating management of the corporate credit union must immediately report the information to the board of directors, supervisory committee, and the OCCU Director. If any violation persists for 30 calendar days, the corporate credit union must submit a detailed, written action plan to the OCCU Director that sets forth the time needed and means by which it intends to correct the violation. If the OCCU Director determines that the plan is unacceptable, the corporate credit union must immediately restructure the balance sheet to bring the exposure back within compliance or adhere to an alternative course of action determined by the OCCU Director.

(f) *Policy violations.* If a corporate credit union's decline in NEV, base case NEV ratio, or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section violates the limits established by its board, it must determine how

it will bring the exposure within policy limits. The disclosure to the board of the violation must occur no later than its next regularly scheduled board meeting.

§ 704.9 Liquidity management.

(a) *General.* In the management of liquidity, a corporate credit union must:

(1) Evaluate the potential liquidity needs of its membership in a variety of economic scenarios;

(2) Regularly monitor sources of internal and external liquidity;

(3) Demonstrate that the accounting classification of investment securities is consistent with its ability to meet potential liquidity demands; and

(4) Develop a contingency funding plan that addresses alternative funding strategies in successively deteriorating liquidity scenarios. The plan must:

(i) List all sources of liquidity, by category and amount, that are available to service an immediate outflow of funds in various liquidity scenarios;

(ii) Analyze the impact that potential changes in fair value will have on the disposition of assets in a variety of interest rate scenarios; and

(iii) Be reviewed by the board or an appropriate committee no less frequently than annually or as market or business conditions dictate.

(b) *Borrowing.* A corporate credit union may borrow up to 10 times capital or 50 percent of shares (excluding shares created by the use of member reverse repurchase agreements) and capital, whichever is greater. CLF borrowings and borrowed funds created by the use of member reverse repurchase agreements are excluded from this limit. The corporate credit union must demonstrate that sufficient contingent sources of liquidity remain available.

§ 704.10 Investment action plan.

(a) Any corporate credit union in possession of an investment, including a derivative, that fails to meet a requirement of this part must, within 30 calendar days of the failure, report the failed investment to its board of directors, supervisory committee and the OCCU Director. If the corporate credit union does not sell the failed investment, and the investment continues to fail to meet a requirement of this part, the corporate credit union must, within 30 calendar days of the failure, provide to the OCCU Director a written action plan that addresses:

(1) The investment's characteristics and risks;

(2) The process to obtain and adequately evaluate the investment's market pricing, cash flows, and risk;

(3) How the investment fits into the credit union's asset and liability management strategy;

(4) The impact that either holding or selling the investment will have on the corporate credit union's earnings, liquidity, and capital in different interest rate environments; and

(5) The likelihood that the investment may again pass the requirements of this part.

(b) The OCCU Director may require, for safety and soundness reasons, a shorter time period for plan development than that set forth in paragraph (a) of this section.

(c) If the plan described in paragraph (a) of this section is not approved by the OCCU Director, the credit union must adhere to the OCCU Director's directed course of action.

§ 704.11 Corporate Credit Union Service Organizations (Corporate CUSOs).

(a) A corporate CUSO is an entity that:

(1) Is at least partly owned by a corporate credit union;

(2) Primarily serves credit unions;

(3) Restricts its services to those related to the normal course of business of credit unions; and

(4) Is structured as a corporation, limited liability company, or limited partnership under state law.

(b) *Investment and loan limitations.* (1) The aggregate of all investments in member and nonmember corporate CUSOs must not exceed 15 percent of a corporate credit union's capital.

(2) The aggregate of all investments in and loans to member and nonmember corporate CUSOs must not exceed 30 percent of a corporate credit union's capital. A corporate credit union may lend to member and nonmember corporate CUSOs an additional 15 percent of capital if the loan is collateralized by assets in which the corporate has a perfected security interest under state law.

(3) If the limitations in paragraphs (b)(1) and (b)(2) of this section are reached or exceeded because of the profitability of the CUSO and the related GAAP valuation of the investment under the equity method without an additional cash outlay by the corporate, divestiture is not required. A corporate credit union may continue to invest up to the regulatory limit without regard to the increase in the GAAP valuation resulting from the corporate CUSO's profitability.

(4) The aggregate of all loans to corporate CUSOs must comply with the aggregate limit of § 723.16 of this chapter. This requirement does not apply to loans excluded under § 723.1(b).

(c) *Due diligence.* A corporate credit union must comply with the due diligence requirements of §§ 723.5 and 723.6(f) through (l) of this chapter for all loans to corporate CUSOs. This requirement does not apply to loans excluded under § 723.1(b).

(d) *Separate entity.* (1) A corporate CUSO must be operated as an entity separate from a corporate credit union.

(2) A corporate credit union investing in or lending to a corporate CUSO must obtain a written legal opinion that concludes the corporate CUSO is organized and operated in a manner that the corporate credit union will not reasonably be held liable for the obligations of the corporate CUSO. This opinion must address factors that have led courts to "pierce the corporate veil," such as inadequate capitalization, lack of corporate identity, common boards of directors and employees, control of one entity over another, and lack of separate books and records.

(e) *Prohibited activities.* A corporate credit union may not use this authority to acquire control, directly or indirectly, of another depository financial institution or to invest in shares, stocks, or obligations of an insurance company, trade association, liquidity facility, or similar organization.

(f) An official of a corporate credit union which has invested in or loaned to a corporate CUSO may not receive, either directly or indirectly, any salary, commission, investment income, or other income, compensation, or consideration from the corporate CUSO. This prohibition also extends to immediate family members of officials.

(g) Prior to making an investment in or loan to a corporate CUSO, a corporate credit union must obtain a written agreement that the corporate CUSO will:

(1) Follow GAAP;

(2) Provide financial statements to the corporate credit union at least quarterly;

(3) Obtain an annual CPA opinion audit and provide a copy to the corporate credit union. A wholly owned or majority owned CUSO is not required to obtain a separate annual audit if it is included in the corporate credit union's annual consolidated audit; and

(4) Allow the auditor, board of directors, and NCUA complete access to its books, records, and any other pertinent documentation.

(h) Corporate credit union authority to invest in or loan to a CUSO is limited to that provided in this section. A corporate credit union is not authorized to invest in or loan to a CUSO under part 712 of this chapter.

§ 704.12 Permissible services.

(a) *Preapproved services.* A corporate credit union may provide to members the preapproved services set out in this section. NCUA may at any time, based upon supervisory, legal, or safety and soundness reasons, limit or prohibit any preapproved service. The specific activities listed within each preapproved category are provided as illustrations of activities permissible under the particular category, not as an exclusive or exhaustive list.

(1) *Correspondent services agreement.* A corporate credit union may only provide financial services to nonmembers through a correspondent services agreement. A correspondent services agreement is an agreement between two corporate credit unions, whereby one of the corporate credit unions agrees to provide services to the other corporate credit union or its members.

(2) *Credit and investment services.* Credit and investment services are advisory and consulting activities that assist the member in lending or investment management. These services may include loan reviews, investment portfolio reviews and investment advisory services.

(3) *Electronic financial services.* Electronic financial services are any services, products, functions, or activities that a corporate credit union is otherwise authorized to perform, provide or deliver to its members but performed through electronic means. Electronic services may include automated teller machines, online transaction processing through a website, website hosting services, account aggregation services, and internet access services to perform or deliver products or services to members.

(4) *Excess capacity.* Excess capacity is the excess use or capacity remaining in facilities, equipment or services that: a corporate credit union properly invested in or established, in good faith, with the intent of serving its members; and it reasonably anticipates will be taken up by the future expansion of services to its members. A corporate credit union may sell or lease the excess capacity in facilities, equipment or services, such as office space, employees and data processing.

(5) *Liquidity and asset and liability management.* Liquidity and asset and liability management services are any services, functions or activities that assist the member in liquidity and balance sheet management. These services may include liquidity planning and balance sheet modeling and analysis.

(6) *Operational services.* Operational services are services established to deliver financial products and services that enhance member service and promote safe and sound operations. Operational services may include tax payment, electronic fund transfers and providing coin and currency service.

(7) *Payment systems.* Payment systems are any methods used to facilitate the movement of funds for transactional purposes. Payment systems may include Automated Clearing House, wire transfer, item processing and settlement services.

(8) *Trustee or custodial services.* Trustee services are services in which the corporate credit union is authorized to act under a written trust agreement to the extent permitted under part 724 of this chapter. Custodial and safekeeping services are services a corporate credit union performs on behalf of its member to act as custodian or safekeeper of investments.

(b) *Procedure for adding services that are not preapproved.* To provide a service to its members that is not preapproved by NCUA:

(1) A federal corporate credit union must request approval from NCUA. The request must include a full explanation and complete documentation of the service and how the service relates to a corporate credit union's authority to provide services to its members. The request must be submitted jointly to the OCCU Director and the Secretary of the Board. The request will be treated as a petition to amend § 704.12 and NCUA will request public comment or otherwise act on the petition within a reasonable period of time. Before engaging in the formal approval process, a corporate credit union should seek an advisory opinion from NCUA's Office of General Counsel as to whether a proposed service is already covered by one of the authorized categories without filing a petition to amend the regulation; and

(2) A state-chartered corporate credit union must submit a request for a waiver that complies with § 704.1(b) to the OCCU Director.

(c) *Prohibition.* A corporate credit union is prohibited from purchasing loan servicing rights.

§ 704.13 [Removed and Reserved].

§ 704.14 Representation.

(a) *Board representation.* The board will be determined as stipulated in its bylaws governing election procedures, provided that:

(1) At least a majority of directors, including the chair of the board, must serve on the board as representatives of member credit unions;

(2) The chair of the board may not serve simultaneously as an officer, director, or employee of a credit union trade association;

(3) A majority of directors may not serve simultaneously as officers, directors, or employees of the same credit union trade association or its affiliates (not including chapters or other subunits of a state trade association);

(4) For purposes of meeting the requirements of paragraphs (a)(2) and (a)(3) of this section, an individual may not serve as a director or chair of the board if that individual holds a subordinate employment relationship to another employee who serves as an officer, director, or employee of a credit union trade association; and

(5) In the case of a corporate credit union whose membership is composed of more than 25 percent non credit unions, the majority of directors serving as representatives of member credit unions, including the chair, must be elected only by member credit unions.

(b) *Credit union trade association.* As used in this section, a credit union trade association includes but is not limited to, state credit union leagues and league service corporations and national credit union trade associations.

(c) *Representatives of organizational members.* (1) An organizational member of a corporate credit union is a member that is not a natural person. An organizational member may appoint one of its

members or officials as a representative to the corporate credit union. The representative shall be empowered to attend membership meetings, to vote, and to stand for election on behalf of the member. No individual may serve as the representative of more than one organizational member in the same corporate credit union.

(2) Any vacancy on the board of a corporate credit union caused by a representative being unable to complete his or her term shall be filled by the board of the corporate credit union according to its bylaws governing the filling of board vacancies.

(d) *Recusal provision.* (1) No director, committee member, officer, or employee of a corporate credit union shall in any manner, directly or indirectly, participate in the deliberation upon or the determination of any question affecting his or her pecuniary interest or the pecuniary interest of any entity (other than the corporate credit union) in which he or she is interested, except if the matter involves general policy applicable to all members, such as setting dividend or loan rates or fees for services.

(2) An individual is "interested" in an entity if he or she:

(i) Serves as a director, officer, or employee of the entity;

(ii) Has a business, ownership, or deposit relationship with the entity; or

(iii) Has a business, financial, or familial relationship with an individual whom he or she knows has a pecuniary interest in the entity.

(3) In the event of the disqualification of any directors, by operation of paragraph (c)(1) of this section, the remaining qualified directors present at the meeting, if constituting a quorum with the disqualified directors, may exercise, by majority vote, all the powers of the board with respect to the matter under consideration. Where all of the directors are disqualified, the matter must be decided by the members of the corporate credit union.

(4) In the event of the disqualification of any committee member by operation of paragraph (c)(1) of this section, the remaining qualified committee members, if constituting a quorum with the disqualified committee members, may exercise, by majority vote, all the powers of the committee with respect to the matter under consideration. Where all of the committee members are disqualified, the matter shall be decided by the board of directors.

(e) *Administration.* (1) A corporate credit union shall be under the direction and control of its board of directors. While the board may delegate the performance of administrative duties, the board is not relieved of its responsibility for their performance. The board may employ a chief executive officer who shall have such authority and such powers as delegated by the board to conduct business from day to day. Such chief executive officer must answer solely to the board of the corporate credit union, and may not be an employee of a credit union trade association.

(2) The provisions of § 701.14 of this chapter apply to corporate credit unions, except that where "Regional Director" is used, read "NCUA Board."

§ 704.15 Audit requirements.

(a) *External audit.* The corporate credit union supervisory committee shall cause an annual opinion audit of the financial statements to be made. The audit must be performed in accordance with generally accepted auditing standards and the audited financial statements must be prepared consistent with GAAP, except where law or regulation has provided for a departure from GAAP. The supervisory committee shall submit the audit report to the board of directors. A copy of the audit report, and copies of all communications that are provided to the corporate credit union by the external auditor, shall be submitted to the OCCU Director within 30 calendar days after receipt by the board of directors. If requested by the OCCU Director, the external auditor's workpapers shall be made available, at the auditor's office or elsewhere, for the OCCU Director's review. The corporate credit union shall submit a summary of the audit report to the membership at the next annual meeting.

(b) *Internal audit.* A corporate credit union with average daily assets in excess of $400 million for the preceding calendar year, or as ordered by the OCCU Director, must employ or contract, on a full- or part-time basis, the services of an internal auditor. The internal auditor's responsibilities will, at a minimum, comply with the Standards and Professional Practices of Internal Auditing, as established by the Institute of Internal Auditors. The internal auditor will report directly to the chair of the corporate credit union's supervisory committee, who may delegate supervision of the internal auditor's daily activities to the chief executive officer of the corporate credit union. The internal auditor's reports, findings, and recommendations will be in writing and presented to the supervisory committee no less than quar-

terly, and will be provided upon request to the external auditor and the OCCU Director.

§ 704.16 Contracts/written agreements.

Services, facilities, personnel, or equipment shared with any party shall be supported by a written contract, with the duties and responsibilities of each party specified and the allocation of service fee/expenses fully supported and documented.

§ 704.17 State-chartered corporate credit unions.

(a) This part does not expand the powers and authorities of any state-chartered corporate credit union, beyond those powers and authorities provided under the laws of the state in which it was chartered.

(b) A state-chartered corporate credit union that is not insured by the NCUSIF, but that receives funds from federally insured credit unions, is considered an "institution-affiliated party" within the meaning of Section 206(r) of the Federal Credit Union Act, 12 U.S.C. 1786(r).

(c) NCUA will notify, consult with, and provide explanation to the appropriate state supervisory authority before taking administrative action against a state-chartered corporate credit union.

§ 704.18 Fidelity bond coverage.

(a) *Scope.* This section provides the fidelity bond requirements for employees and officials in corporate credit unions.

(b) *Review of coverage.* The board of directors of each corporate credit union shall, at least annually, carefully review the bond coverage in force to determine its adequacy in relation to risk exposure and to the minimum requirements in this section.

(c) *Minimum coverage; approved forms.* Every corporate credit union will maintain bond coverage with a company holding a certificate of authority from the Secretary of the Treasury. All bond forms, and any riders and endorsements which limit the coverage provided by approved bond forms, must receive the prior written approval of NCUA. Fidelity bonds must provide coverage for the fraud and dishonesty of all employees, directors, officers, and supervisory and credit committee members. Notwithstanding the foregoing, all bonds must include a provision, in a form approved by NCUA, requiring written notification by surety to NCUA:

(1) When the bond of a credit union is terminated in its entirety;

(2) When bond coverage is terminated, by issuance of a written notice, on an employee, director, officer, supervisory or credit committee member; or

(3) When a deductible is increased above permissible limits. Said notification shall be sent to NCUA and shall include a brief statement of cause for termination or increase.

(d) *Minimum coverage amounts.* (1) The minimum amount of bond coverage will be computed based on the corporate credit union's daily average net assets for the preceding calendar year. The following table lists the minimum requirements:

Daily average net assets	Minimum bond (million)
Less than $50 million	$1.0
$50–$99 million	2.0
$100–$499 million	4.0
$500–$999 million	6.0
$1.0–$1.999 billion	8.0
$2.0–$4.999 billion	10.0
$5.0–$9.999 billion	15.0
$10.0–$24.999 billion	20.0
$25.0 billion plus	25.0

(2) It is the duty of the board of directors of each corporate credit union to provide adequate protection to meet its unique circumstances by obtaining, when necessary, bond coverage in excess of the minimums in the table in paragraph (d)(1) of this section.

(e) *Deductibles.* (1) The maximum amount of deductibles allowed are based on the corporate credit union's core capital ratio. The following table sets out the maximum deductibles, except that in each category the maximum deductible shall be $5 million:

Core Capital ratio	Maximum deductible
Less than 1.0 percent	7.5 percent of the sum of retained earnings and paid-in capital.
1.0–1.74 percent	10.0 percent of the sum of retained earnings and paid-in capital.
1.75–2.24 percent	12.0 percent of the sum of retained earnings and paid-in capital.
Greater than 2.25 percent	15.0 percent of the sum of retained earnings and paid-in capital.

(2) A deductible may be applied separately to one or more insuring clauses in a blanket bond. Deductibles in excess of those showing in this section must have the written approval of NCUA at least 30 calendar days prior to the effective date of the deductibles.

(f) *Additional coverage.* NCUA may require additional coverage for any corporate credit union when, in the opinion of NCUA, current coverage is insufficient. The board of directors of the corporate credit union must obtain additional coverage within 30 calendar days after the date of written notice from NCUA.

§ 704.19 Wholesale corporate credit unions.

(a) *General.* Wholesale corporate credit unions are subject to the preceding requirements of this part, except as set forth in this section.

(b) *Earnings retention requirement.* A wholesale corporate credit union must increase retained earnings if the prior month-end retained earnings ratio is less than 1 percent.

(1) Its retained earnings must increase:

(i) During the current month, by an amount equal to or greater than the monthly earnings retention amount; or

(ii) During the current and prior two months, by an amount equal to or greater than the quarterly earnings retention amount.

(2) Earnings retention amounts are calculated as follows:

(i) The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month-end moving daily average net assets; and

(ii) The quarterly earnings retention amount is determined by multiplying the earnings retention factor by moving daily average net assets for each of the prior three month-ends.

(3) The earnings retention factor is determined as follows:

(i) If the prior month-end retained earnings ratio is less than 1 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or

(ii) If the prior month-end retained earnings ratio is less than 1 percent and the core capital ratio is equal to or greater than 3 percent, the earnings retention factor is .075 percent per annum.

(4) The OCCU Director may approve a decrease to the earnings retention amount set forth in this section if it is determined a lesser amount is necessary to avoid a significant adverse impact upon a wholesale corporate credit union.

(5) Operating management of the wholesale corporate credit union must notify its board of directors, supervisory committee, OCCU Director and, if applicable, the state regulator within 10 calendar days of determining the retained earnings ratio has declined below 1 percent. If the decline in the retained earnings ratio is due in full or in part, to a decline in the dollar amount of retained earnings and the retained earnings ratio is not restored to at least 1 percent by the next month end, a retained earnings action plan is required to be submitted within 30 calendar days.

(6) The retained earnings action plan must be submitted to the OCCU Director and, if applicable, the state regulator and, at a minimum, include the following:

(i) Reasons why the dollar amount of retained earnings has decreased;

(ii) Description of actions to be taken to increase the dollar amount of retained earnings within specific time frames; and

(iii) Monthly balance sheet and income projections, including assumptions for the ensuing 12-month period.

Appendix A to Part 704—Model Forms

This appendix contains sample forms intended for use by corporate credit unions to aid in compliance with the membership capital account and paid-in capital disclosure requirements of § 704.3.

SAMPLE FORM 1

Terms and Conditions of Membership Capital Account

(1) A membership capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A membership capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the membership capital account transfers to the continuing credit union. In the event of a charter conversion, the membership capital account transfers to the new institution.

In the event of liquidation, the membership capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) A member credit union may withdraw membership capital with three years' notice.

(4) Membership capital cannot be used to pledge borrowings.

(5) Membership capital is available to cover losses that exceed retained earnings and paid-in capital.

(6) Where the corporate credit union is liquidated, membership capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF.

(7) Where the corporate credit union is merged into another corporate credit union, the membership capital account will transfer to the continuing corporate credit union. The three-year notice period for withdrawal of the membership capital account will remain in effect.

(8) {If an adjusted balance account}: The membership capital balance will be adjusted ____(1 or 2)____ time(s) annually in relation to the member credit union's _____(assets or other measure)_____ as of _____(date(s))_____. {If a term certificate}: The membership capital account is a term certificate that will mature on _____(date)_____.

I have read the above terms and conditions and I understand them.

I further agree to maintain in the credit union's files the annual notice of terms and conditions of the membership capital account.

The notice form must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the notice has been sent to member credit unions with membership capital accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

SAMPLE FORM 2

Terms and Conditions of Paid-In Capital

(1) A paid-in capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A paid-in capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the paid-in capital account transfers to the continuing credit union. In the event of a charter conversion, the paid-in capital account transfers to the new institution. In the event of liquidation, the paid-in capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) The funds are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum required capital and NEV ratios after the funds are called.

(4) Paid-in capital cannot be used to pledge borrowings.

(5) Paid-in capital is available to cover losses that exceed retained earnings.

(6) Where the corporate credit union is liquidated, paid-in capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, and membership capital holders.

(7) Where the corporate credit union is merged into another corporate credit union, the paid-in capital account will transfer to the continuing corporate credit union.

(8) Paid-in capital is perpetual maturity and noncumulative dividend.

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and conditions of the paid-in capital instrument.

The notice form must be signed by either all of the directors of the credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

Appendix B to Part 704—Expanded Authorities and Requirements

A corporate credit union may obtain all or part of the expanded authorities contained in this Appendix if it meets the applicable requirements of Part 704 and Appendix B, fulfills additional management, infrastructure, and asset and liability requirements, and receives NCUA's written approval. Additional guidance is set forth in the NCUA publication Guidelines for Submission of Requests for Expanded Authority.

A corporate credit union seeking expanded authorities must submit to NCUA a self-assessment plan supporting its request. A corporate credit union may adopt expanded authorities when NCUA has provided final approval. If NCUA denies a request for expanded authorities, it will advise the corporate credit union of the reason(s) for the denial and what it must do to resubmit its request. NCUA may revoke these expanded authorities at any time if an analysis indicates a significant deficiency. NCUA will notify the corporate credit union in writing of the identified deficiency. A corporate credit union may request, in writing, reinstatement of the revoked authorities by providing a self-assessment plan detailing how it has corrected the deficiency.

Minimum Requirement

In order to participate in any of the authorities set forth in Base-Plus, Part I, Part II, Part III, Part IV, and Part V of this Appendix, a corporate credit union must evaluate monthly the changes in NEV and the NEV ratio for the tests set forth in § 704.8(d)(1)(i).

Base-Plus

A corporate that has met the requirements for this Base-plus authority may, in performing the rate stress tests set forth in § 704.8(d)(1)(i), allow its NEV to decline as much as 20 percent.

Part I

(a) A corporate credit union that has met the requirements for this Part I may:

(1) Purchase investments with long-term ratings no lower than A– (or equivalent);

(2) Purchase investments with short-term ratings no lower than A–2 (or equivalent), provided that the issuer has a long-term rating no lower than A– (or equivalent) or the investment is a domestically-issued asset-backed security;

(3) Engage in short sales of permissible investments to reduce interest rate risk;

(4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk; and

(5) Enter into a dollar roll transaction.

(b) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 300 percent of capital.

(c) In performing the rate stress tests set forth in § 704.8(d)(1)(i), the NEV of a corporate credit union that has met the requirements of this Part I may decline as much as:

(1) 20 percent;

(2) 28 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA; or

(3) 35 percent if the corporate credit union has a 6 percent minimum capital ratio and is specifically approved by NCUA.

(d) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 100 percent of the corporate credit union's capital. The board of directors must establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

Part II

(a) A corporate credit union that has met the requirements for this Part II may:

(1) Purchase investments with long-term ratings no lower than BBB (flat) (or equivalent). The aggregate of all investments rated BBB+ (or equivalent) or lower in any single obligor is not to exceed 25 percent of capital;

(2) Purchase investments with short-term ratings no lower than A–2 (or equivalent), provided that the issuer has a long-term rating no lower than BBB (flat) (or equivalent) or the investment is a domestically issued asset-backed security;

(3) Engage in short sales of permissible investments to reduce interest rate risk;

(4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk; and

(5) Enter into a dollar roll transaction.

(b) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 400 percent of capital.

(c) In performing the rate stress tests set forth in § 704.8(d)(1)(i), the NEV of a corporate credit union which has met the requirements of this Part II may decline as much as:

(1) 20 percent;

(2) 28 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA; or

(3) 35 percent if the corporate credit union has a 6 percent minimum capital ratio and is specifically approved by NCUA.

(d) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 100 percent of the corporate credit union's capital. The board of directors must establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

Part III

(a) A corporate credit union that has met the requirements of either Part I or Part II of this Appendix and the additional requirements for Part III may invest in:

(1) Debt obligations of a foreign country;

(2) Deposits and debt obligations of foreign banks or obligations guaranteed by these banks;

(3) Marketable debt obligations of foreign corporations. This authority does not apply to debt obligations that are convertible into the stock of the corporation; and

(4) Foreign issued asset-backed securities.

(b) All foreign investments are subject to the following requirements:

(1) Investments must be rated no lower than the minimum permissible domestic rating under the corporate credit union's Part I or Part II authority;

(2) A sovereign issuer, and/or the country in which an obligor is organized, must have a long-term foreign currency (non-local currency) debt rating no lower than AA– (or equivalent);

(3) For each approved foreign bank line, the corporate credit union must identify the specific banking centers and branches to which it will lend funds;

(4) Obligations of any single foreign obligor may not exceed 50 percent of capital; and

(5) Obligations in any single foreign country may not exceed 250 percent of capital.

Part IV

(a) A corporate credit union that has met the requirements for this Part IV may enter into derivative transactions specifically approved by NCUA to:

(1) Create structured products;

(2) Manage its own balance sheet; and

(3) Hedge the balance sheets of its members.

(b) Credit Ratings:

(1) All derivative transactions are subject to the following requirements:

(i) If the counterparty is domestic, the counterparty rating must be no lower than the minimum permissible rating for comparable term permissible investments; and

(ii) If the counterparty is foreign, the corporate must have Part III expanded authority and the counterparty rating must be no lower that the minimum permissible rating for a comparable term investment under Part III Authority.

(iii) Any rating(s) relied upon to meet the requirements of this part must be identified at the time the transaction is entered into and must be monitored for as long as the contract remains open.

(iv) Section 704.10 of this part if:

(A) one rating was relied upon to meet the requirements of this part and that rating is downgraded below the minimum rating requirements of this part; or

(B) two or more ratings were relied upon to meet the requirements of this part and at least two of those ratings are downgraded below the minimum rating requirements of this part.

(2) Exceptions. Credit ratings are not required for derivative transactions with:

(i) Domestically chartered credit unions;

(ii) U.S. government sponsored enterprises; or

(iii) Counterparties if the transaction is fully guaranteed by an entity with a minimum permissible rating for comparable term investments.

Part V

A corporate credit union that has met the requirements for this Part V may participate in loans with member natural person credit unions as approved by the OCCU Director and subject to the following:

(a) The maximum aggregate amount of participation loans with any one member credit union must not exceed 25 percent of capital; and

(b) The maximum aggregate amount of participation loans with all member credit unions will be determined on a case-by-case basis by the OCCU Director.

(ii) Involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate; or

(9) The regional director has granted a waiver from the appraisal requirement for a category of loans meeting the definition of a member business loan.

(b) *Transactions Requiring a State-Certified Appraiser.*

(1) (All transactions of $1,000,000 or more) All federally related transactions having a transaction value of $1,000,000 or more shall require an appraisal prepared by a state-certified appraiser.

(2) (Nonresidential transactions) All federally related transactions having a transaction value of more than $250,000, other than those involving appraisals of 1-to-4 family residential properties, shall require an appraisal prepared by a state-certified appraiser.

(3) (Complex residential transactions of $250,000 or more) All complex 1-to-4 family residential property appraisals rendered in connection with federally related transactions shall require a state-certified appraiser if the transaction value is $250,000 or more. A regulated institution may presume that appraisals of 1-to-4 family residential properties are not complex unless the institution has readily available information that a given appraisal will be complex. The regulated institution shall be responsible for making the final determination of whether the appraisal is complex. If, during the course of the appraisal, a licensed appraiser identifies factors that would result in the property, form of ownership, or market conditions being considered atypical, then either:

(i) the regulated institution may ask the licensed appraiser to complete the appraisal and have a certified appraiser approve and cosign the appraisal; or

(ii) the institution may engage a certified appraiser to complete the appraisal.

(c) *Transactions Requiring Either a State-Certified or -Licensed Appraiser.* All appraisals for federally related transactions not requiring the services of a state-certified appraiser shall be prepared by either a state-certified appraiser or a state-licensed appraiser.

(d) *Valuation requirement.* Secured transactions exempted from appraisal requirements pursuant to paragraphs (a)(1) and (a)(5) of this section and not otherwise exempted from this regulation or fully insured shall be supported by a written estimate of market value, as defined in this part, performed by an individual having no direct or indirect interest in the property, and qualified and experienced to perform such estimates of value for the type and amount of credit being considered.

(e) *Appraisals to address safety and soundness concerns.* NCUA reserves the right to require an appraisal under this part whenever the agency believes it is necessary to address safety and soundness concerns.

§ 722.4 Minimum appraisal standards.

For federally related transactions, all appraisals shall, at a minimum:

(a) Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board of the Appraisal Foundation, 1029 Vermont Ave., NW., Washington, DC 20005;

(b) Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

(c) Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units;

(d) Be based upon the definition of market value as set forth in § 722.2(f); and

(e) Be performed by State licensed or certified appraisers in accordance with requirements set forth in this part.

§ 722.5 Appraiser Independence.

(a) *Staff Appraiser.* If an appraisal is prepared by a staff appraiser, that appraiser must be independent of the lending, investment, and collection functions and not involved, except as an appraiser, in the federally related transaction, and have no direct or indirect interest, financial or otherwise, in the property. If the only qualified persons available to perform an appraisal are involved in the lending, investment, or collection functions of the credit union, the credit union shall take appropriate steps to ensure that the appraisers exercise independent judgment. Such steps include, but are not limited to, prohibiting an individual from performing an appraisal in connection with feder-

ally related transactions in which the appraiser is otherwise involved.

(b) *Fee Appraisers.* (1) If an appraisal is prepared by a fee appraiser, the appraiser shall be engaged directly by the credit union or its agent and have no direct or indirect interest, financial or otherwise, in the property or the transaction.

(2) A credit union also may accept an appraisal that was prepared by an appraiser engaged directly by another financial services institution; if:

(i) the appraiser has no direct or indirect interest, financial or otherwise, in the property or transaction; and

(ii) the credit union determines that the appraisal conforms to the requirement of this part and is otherwise acceptable.

§ 722.6 Professional Association Membership; Competency.

(a) *Membership in Appraisal Organization.* A state-certified appraiser or a state-licensed appraiser may not be excluded from consideration for an assignment for a federally related transaction solely by virtue of membership or lack of membership in any particular appraisal organization.

(b) *Competency.* All staff and fee appraisers performing appraisals in connection with federally related transactions must be state-certified or -licensed as appropriate. However, a state-certified or -licensed appraiser may not be considered competent solely by virtue of being certified or licensed. Any determination of competency shall be based upon the individual's experience and educational background as they relate to the particular appraisal assignment for which he or she is being considered.

§ 722.7 Enforcement.

Credit unions and institution-affiliated parties, including staff appraisers, may be subject to removal and/or prohibition orders, cease-and-desist orders, and the imposition of civil money penalties pursuant to Section 1786 of the Federal Credit Union Act, or any other applicable law.

Part 741

Requirements for Insurance

§ 741.0 Scope.

The provisions of this part apply to federal credit unions, federally insured state-chartered credit unions, and credit unions making application for insurance of accounts pursuant to Title II of the Act, unless the context of a provision indicates its application is otherwise limited. This part prescribes various requirements for obtaining and maintaining federal insurance and the payment of insurance premiums and capitalization deposit. Subpart A of this part contains substantive requirements that are not codified elsewhere in this chapter. Subpart B of this part lists additional regulations, set forth elsewhere in this chapter as applying to federal credit unions, that also apply to federally insured state-chartered credit unions. As used in this part, "insured credit union" means a credit union whose accounts are insured by the National Credit Union Share Insurance Fund (NCUSIF).

Subpart A—Regulations that Apply to Both Federal Credit Unions and Federally Insured State-Chartered Credit Unions and That are not Codified Elsewhere in NCUA's Regulations

§ 741.1 Examination.

As provided in Sections 201 and 204 of the Act (12 U.S.C. 1781 and 1784), the NCUA Board is authorized to examine any insured credit union or any credit union making application for insurance of its accounts. Such examination may require access to all records, reports, contracts to which the credit union is a party, and information concerning the affairs of the credit union. Upon request, such documentation must be provided to the NCUA Board or its representative. Any credit union which makes application for insurance will be required to pay the cost of such examination and processing. To the maximum extent feasible, the NCUA Board will utilize examinations conducted by state regulatory agencies.

§ 741.2 Maximum borrowing authority.

Any credit union which makes application for insurance of its accounts pursuant to Title II of the Act, or any insured credit union, must not borrow, from any source, an aggregate amount in excess of 50 per centum of its paid-in and unimpaired capital and surplus (shares and undivided earnings, plus net income or minus net loss).

§ 741.3 Criteria.

In determining the insurability of a credit union which makes application for insurance and in continuing the insurability of its accounts pursuant to Title II of the Act, the following criteria shall be applied:

(a) *Reserves*—(1) *General rule.* State-chartered credit unions are subject to section 216 of the Act, 12 U.S.C. 1790d, and to part 702 and subpart L of part 747 of this chapter.

(2) *Special reserve for nonconforming investments.* State-chartered credit unions (except state-chartered corporate credit unions) are required to establish an additional special reserve for investments if those credit unions are permitted by their respective state laws to make investments beyond those authorized in the Act or the NCUA Rules and Regulations. For any investment other than loans to members and obligations or securities expressly authorized in Title I of the Act and part 703 of this chapter, as amended, state-chartered credit unions (except state-chartered corporate credit unions) are required to establish and maintain at the end of each accounting period and prior to payment of any dividend, an Appropriation for Non-conforming Investments in an amount at least equal to the net excess of book value over current market value of the investments. If the market value cannot be determined, an amount equal to the full book value will be established. When at the end of any dividend period, the amount in the Appropriation for Non-conforming Investments exceeds the dif-

ference between book value and market value, the board of directors may authorize the transfer of the excess to Undivided Earnings.

(b) *Financial condition and policies.* The following factors are to be considered in determining whether the credit union's financial condition and policies are both safe and sound:

(1) The existence of unfavorable trends which may include excessive losses on loans (i.e., losses which exceed the regular reserve or its equivalent [in the case of state-chartered credit unions] plus other irrevocable reserves established as a contingency against losses on loans), the presence of special reserve accounts used specifically for charging off loan balances of deceased borrowers, and an expense ratio so high that the required transfers to reserves create a net operating loss for the period or that the net gain after these transfers is not sufficient to permit the payment of a nominal dividend;

(2) The existence of written lending policies, including adequate documentation of secured loans and the protection of security interests by recording, bond, insurance, or other adequate means, adequate determination of the financial capacity of borrowers and co-makers for repayment of the loan, and adequate determination of value of security on loans to ascertain that said security is adequate to repay the loan in the event of default;

(3) Investment policies which are within the provisions of applicable law and regulations, i.e., the Act and part 703 of this chapter for federal credit unions and the laws of the state in which the credit union operates for state-chartered credit unions, except state-chartered corporate credit unions. State-chartered corporate credit unions are permitted to make only those investments that are in conformance with part 704 of this chapter and applicable state laws and regulations;

(4) The presence of any account or security, the form of which has not been approved by the Board, except for accounts authorized by state law for state-chartered credit unions.

(c) *Fitness of management.* The officers, directors, and committee members of the credit union must have conducted its operations in accordance with provisions of applicable law, regulations, its charter and bylaws. No person shall serve as a director, officer, committee member, or employee of an insured credit union who has been convicted of any criminal offense involving dishonesty or breach of trust, except with the written consent of the Board.

(d) *Insurance of member accounts would not otherwise involve undue risk to the NCUSIF.* The credit union must maintain adequate fidelity bond coverage as specified in § 741.201. Any circumstances which may be unique to the particular credit union concerned shall also be considered in arriving at the determination of whether or not an undue risk to the NCUSIF is or may be present. For purposes of this section, the term "undue risk to the NCUSIF" is defined as a condition which creates a probability of loss in excess of that normally found in a credit union and which indicates a reasonably foreseeable probability of the credit union becoming insolvent because of such condition, with a resultant claim against the NCUSIF.

(e) *Powers and purposes.* The credit union must not perform services other than those which are consistent with the promotion of thrift and the creation of a source of credit for its members, except as otherwise permitted by law or regulation.

(f) *Letter of disapproval.* A credit union whose application for share insurance is disapproved shall receive a letter indicating the reasons for such disapproval, a citation of the authority for such disapproval, and suggested methods by which the applying credit union may correct its deficiencies and thereby qualify for share insurance.

(g) Nothing in this section shall preclude the NCUA Board from imposing additional terms or conditions pursuant to the insurance agreement.

tory supervisory action under part 702 of this chapter, the NCUA Board may seek enforcement of the directive in the appropriate United States District Court pursuant to 12 U.S.C. 1786(k)(1).

(b) *Administrative remedies*—(1) *Failure to comply with directive.* Pursuant to 12 U.S.C. 1786(k)(2)(A), the NCUA Board may assess a civil money penalty against any credit union that violates or otherwise fails to comply with any final directive issued under part 702 of this chapter, or against any institution-affiliated party of a credit union (per 12 U.S.C. 1786(r)) who participates in such violation or noncompliance.

(2) *Failure to implement plan.* Pursuant to 12 U.S.C. 1786(k)(2)(A), the NCUA Board may assess a civil money penalty against a credit union which fails to implement a net worth restoration plan under subpart B of part 702 of this chapter or a revised business plan under subpart C of part 702, regardless whether the plan was published.

(c) *Other enforcement action.* In addition to the actions described in paragraphs (a) and (b) of this section, the NCUA Board may seek enforcement of the directives issued under part 702 of this chapter through any other judicial or administrative proceeding authorized by law.

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 703 and 704

Investment and Deposit Activities; Corporate Credit Unions

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final rule.

SUMMARY: NCUA is issuing final revisions to the rule governing corporate credit unions (corporates). The major revisions to the rule are in the areas of capital, credit concentration limits and services. The amendments enable corporates to remain competitive in the marketplace while retaining NCUA's historic focus on the safety and soundness of the corporate credit union system. The major changes to these areas necessitate some substantive changes to other provisions of the rule. Several other minor revisions are generally either a clarification or a modernization of the existing rule.

DATES: This rule is effective November 25, 2002, except that the revision of the definition ''paid-in capital'' in § 704.2 is effective July 1, 2003. Compliance with this rule is not required until January 1, 2003.

FOR FURTHER INFORMATION CONTACT: Kent Buckham, Director, Office of Corporate Credit Unions, 1775 Duke Street, Alexandria, Virginia 22314–3428 or telephone (703) 518–6640; or Mary Rupp, Staff Attorney, Office of General Counsel, at the above address or telephone (703) 518–6540.

SUPPLEMENTARY INFORMATION:

A. Background

On July 28, 1999, and November 22, 2000, NCUA issued advance notices of proposed rulemaking (ANPRs). 64 FR 40787, July 28, 1999; 65 FR 70319, November 22, 2000. Based on the comments received in response to the ANPRs, the Board issued a proposed rule. 66 FR 48742, September 21, 2001. In response to the comments received, particularly in the area of capital, the Board issued a revised proposed rule for another round of public comment. 67 FR 44270, July 1, 2002. The Board received 37 comments on the revised proposal: 22 from corporate credit unions, six from natural person credit unions, four from credit union trade associations, two from bank trade associations, two from state credit union leagues and one from a research firm. The commenters appreciated the Board's willingness to issue a revised proposal. The comments to the revised proposed rule have greatly assisted the Board in drafting the final rule and will be discussed in the relevant section of the section-by-section analysis.

B. Section-by-Section Analysis

Natural Person Credit Union Investments, Section 703.100

As in the initial proposed rule, the Board retained an increase in the limit on a natural person credit union's aggregate purchase of paid-in capital (PIC) and membership capital (MC) in one corporate to 2 percent of the credit union's assets measured at the time of purchase. Additionally, the Board retained the limit on a credit union's aggregate purchase of PIC and MC in all corporates of 4 percent.

Two commenters, both bank trade groups, noted continued opposition to the proposed increase. The commenters argued that it increases exposure to individual credit unions and raises the overall systemic risk. One commenter expressed support for the proposal but indicated the limit should be based on the natural person credit union's net worth rather than on its assets.

The Board remains convinced the revised limits on natural person credit union investments in PIC and MC in an individual corporate and in the aggregate are in the best interest of the credit union system. These changes have been retained in the final rule.

Definitions, Section 704.2

Daily Average Net Assets (DANA)

Although not specifically addressed in the rule, nineteen commenters continued to oppose the guidance on DANA issued by the Office of Corporate Credit Union (OCCU) in 2000 that was discussed in the preamble. Corporate Credit Union Guidance Letter No. 2000–03, August 30, 2000. The letter addressed the inclusion of future dated ACH items and uncollected cash letters that are perfectly matched on both the asset and liability sides of the balance sheet in the definition of DANA. As noted in the revised proposal, the issue is whether such transactions should be recorded on their settlement date (the date the funds are posted) or on the advice date (the date the corporate receives an advice indicating the funds will posted on a specific future date). 67 FR at 4270. All of the commenters on this issue noted their preference for recording these transactions on the settlement date.

The commenters stated that, while the American Institute of Certified Public Accountants (AICPA) has not taken an official position on this specific issue, there exists professional accounting guidance supporting exclusion of future dated ACH transactions from the definition of DANA. For example, the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concept's No. 6—Elements of Financial Statements defines liabilities as ''probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entitles as a result of past transactions or events.'' FASB No. 6 goes on to state that an item is not a liability ''if the item involves a future sacrifice of assets that the entity will be obligated to make, but the events or circumstances that obligate the entity have not yet occurred.'' A number of commenters indicated they are under no legal obligation to pay the transactions on the advice date. Several commenters also noted that some corporates have received opinions from their CPA firms indicating accounting for such transactions as of the advice date is not in accordance with Generally Accepted Accounting Principles (GAAP).

The Board believes it is important to have consistency among corporates, as well with the other financial regulators. To ensure NCUA's position on this issue is consistent with that taken by the other financial regulators, NCUA staff contacted the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision and the Federal Reserve Board. All of these financial regulators require their financial institutions to report future dated ACH transactions on their call reports as of the advice date. None of the financial regulators exclude future dated ACH transactions from their regulatory ratio calculations. As such, NCUA's position is consistent with the other financial regulators.

The Board remains convinced that a corporate should report future dated ACH items and uncollected cash letters on the advice date for both regulatory and 5310 (Corporate Credit Union Call Report) reporting purposes. For other financial statement reporting, corporates should follow their CPA firm's guidance.

Capital, Section 704.3

One commenter indicated the Board should not set a regulatory standard for each type of capital account, including retained earnings. The commenter suggests each corporate set its own limits for each type of capital it wants to hold. NCUA should just set a minimum overall capital level. Several commenters indicated that PIC should be counted equally with regular reserves and undivided earnings (RUDE) in all areas of the regulation.

One commenter recommended limiting the aggregate amount of MC and PIC that can be used to satisfy the total capital requirement to 100 percent of RUDE. One commenter indicated that the amount of MC that can be counted as ''core capital'' should be limited to 50 percent of retained earnings and PIC.

The Board is not persuaded to revise the treatment of the various capital accounts. The Board believes there is a very important distinction between internally generated capital, retained earnings, and other types of capital accounts. The Board continues to believe an adequate level of internally generated capital is essential to avoid erosion of member confidence in the event losses occur. The final regulation provides an adequate capital structure and appropriate types of capital accounts for corporates.

Requirements for Membership Capital, Section, 704.3(b)

The Board addresses the comments to this provision in conjunction with its discussion of the comments on Appendix A, Model Forms.

Requirements for Paid-in Capital, Section, 704.3(c)

One commenter suggested removing the prohibition conditioning membership, services, or prices for services on a credit union's ownership of PIC. The commenter indicated that PIC is no longer considered a temporary measure to strengthen capital, and the same restriction is not placed on MC. The Board continues to believe it is in the best interest of natural person credit unions and their members to be able to obtain the most efficient and cost effective services available. The Board does not want, in effect, to force natural person credit unions to commit to a long-term PIC account as a means of obtaining service or membership. PIC was intended to be an additional means for corporates to strengthen their levels of capital. The Board believes a natural person credit union's decision to invest in PIC should be based on its commitment to the corporate, not a requirement to obtain services. Forcing natural person credit unions to obtain PIC as a condition of membership may have the unintended consequence of having them seek products and services outside the system.

Fifteen commenters requested a ''grandfathering'' period ranging from 12 to 24 months on the implementation of the revised definition of PIC. While supportive of the change making PIC a perpetual, non-cumulative dividend account, the commenters believe that immediate adoption of the definition might give a competitive advantage to those corporates that issued PIC under the existing regulatory definition. Several commenters noted that some corporates held off issuing PIC to see what the regulatory changes were before dedicating the time and expense to that endeavor.

The Board views the issuance of PIC as a business decision for corporates. In response to the comments, the Board will permit corporates to issue PIC under the current definition of PIC until June 30, 2003. The effective date of the revised definition of PIC is delayed until July 1, 2003.

Earnings Retention Requirement, Section, 704.3(i)

Based on comments to the proposed rule, the Board in the revised proposal eliminated the requirement that established a minimum RUDE to moving DANA ratio of 2 percent. Three commenters opposed this action and requested the minimum RUDE ratio be reinstated.

In place of a minimum RUDE ratio, the Board proposed an earnings retention requirement. Five commenters indicated they supported the intent of the earnings retention requirement, but not the proposal in full. Seven commenters opposed the earnings retention requirement.

A number of commenters suggested the process for calculating the earnings retention ratio is virtually impossible because dividends are paid throughout the month on various accounts. Due to the timing of when financial statements are prepared, losses or expenses may not be fully appreciated until after dividends have already been paid. A corporate might pay dividends without realizing it had gone below the 2 percent level.

Four commenters indicated that PIC should be included with retained earnings in the earnings retention calculation. Another commenter suggested excluding the gains/losses on the sale of fixed assets and other non-operating gains/losses from the earnings retention calculation. One commenter suggested calculating the earnings retention requirement only on a quarterly basis, and another commenter suggested calculating on a year-to-year rather than month-to-month basis. One commenter believed that a total capital ratio alone would be sufficient for monitoring capital in corporate credit unions. Another commenter suggested that capital requirements for each corporate be based on the risk in that specific institution.

Twenty-seven commenters objected to the dividend restrictions in § 704.3(i)(5). Numerous commenters expressed concern that the dividend restrictions might give their competitors an advantage over credit union deposits. Many also expressed concern that natural person credit unions would seek riskier investments if they believed the corporate may be unable to pay dividends. This could result in a negative impact on the entire credit union system. Several commenters also noted that smaller natural person credit unions would be the most severely affected as they rely heavily on the dividends they earn from their deposits in corporates. Two commenters recommended that a corporate that falls below 2 percent be allowed to pay dividends, but be required to submit an earnings retention plan. Two other commenters objected to the dividend restrictions for state-chartered corporates because it moves control over undivided earnings out of the hands of the corporates and the state regulators and into the hands of the federal deposit insurer. One commenter noted that, even if NCUA were flexible in its approach to approving dividend payments, the perception of increased risk would have inflicted damage to the credit union network. Several commenters indicated that NCUA already has adequate regulatory and supervisory tools to ensure corporates build and maintain an appropriate level of capital.

Ten commenters recommended the adoption of a credit-risk weighted capital requirement as the best means of measuring capital in corporate credit unions.

The Board continues to believe that an earnings retention requirement is the appropriate means of ensuring adequate retained earnings on an ongoing basis. As noted in the preamble of the revised proposed rule, the Board is concerned that a minimum RUDE ratio may have the unintended consequence of limiting the traditional role of corporates as depositors of excess liquidity for natural person credit unions. The Board also believes, as stated numerous times in the past, that a credit-risk weighted capital requirement is not the best measure of risk in corporates. 67 FR at 44273.

The Board agrees failure to pay dividends would have a dramatic impact on a corporate, its members, and, potentially, the entire credit union system. The intent of proposed § 704.3(i)(5) was to ensure cooperative action between the corporate and NCUA and, if applicable, the state regulator in building retained earnings that have fallen below the minimum desired level. Therefore, the Board is persuaded that

§ 704.3(i)(5) should be revised to address the commenters' concerns while retaining the original intent of the proposed regulation. Any restriction on the payment of dividends has been eliminated from the final rule.

The final rule requires operational management of corporates to notify the board of directors, supervisory committee, OCCU Director and, if applicable, the state regulator if the retained earnings ratio falls below 2 percent. Notification of the occurrence is sufficient if the decrease in the retained earnings ratio is due solely to the increase in moving DANA and the dollar amount of retained earnings has remained constant or increased. This places no additional burden on a corporate that has an influx of funds due to excess liquidity in natural person credit unions.

If a corporate's retained earnings ratio declines below 2 percent due, in full or in part, to a decline in the dollar amount of retained earnings and the retained earnings ratio is not restored to at least 2 percent by the next month end, the corporate will be required to submit a retained earnings action plan.

The Board believes NCUA has sufficient supervisory authority over corporates, coupled with the notification and the retained earnings action plan requirements, to work with officials to address a decline in the retained earnings ratio below 2 percent in a timely and effective manner.

The Board is satisfied that the existing retained earnings ratio calculation method is sufficient. The timing of the notification within 10 calendar days is based on the date the determination is made that the retained earnings ratio has fallen below 2 percent. If necessary, the timing of the submission of a retained earnings action plan within 30 calendar days is based on the next month end after the month in which the retained earnings ratio has fallen below 2 percent. In some cases, the determination may be made during the month, while in other cases the determination may not be made until after the books are closed at the end of the month.

Board Responsibilities, Section 704.4

The revised proposed rule changed the term ''operating policies'' to ''policies'' throughout this section and changed the title of subsection (c) to ''Other requirements.'' The commenters supported this change and it has been retained as proposed.

Investments, Section 704.5

The revised proposed rule deleted several investment related definitions no longer used in the regulation and amended the definitions of: Asset-backed security (ABS), Collateralized mortgage obligation (CMO), Forward settlement, Quoted market price, Mortgage related security, Regular-way settlement, Repurchase transaction, and Residual interest. One commenter suggested including the acronym ''ABS'' in the title for asset-backed security. The Board agrees, and the final rule includes the acronym. No commenters objected to the other provisions, and they have been deleted or amended as proposed.

Two commenters expressed concern about possible erroneous categorizations of home equity backed securities on the 5310 Call Report in light of the revised definitions of mortgage related security and asset-backed security. If there is any uncertainty about appropriate reporting, a corporate is encouraged to discuss the matter with its corporate examiner.

One commenter suggested deleting the definitions of: Credit enhancement; Dealer bid indication; Industry recognized information provider; Matched; and Small business related security, if they are no longer used in the regulation. The Board agrees and is deleting the first four terms since they are no longer used but is retaining the definition of ''small business related security'' since that term is used in § 704.5(h)(4).

Policies, Section 704.5(a)

The revised proposed rule combined the policy requirements in this section and deleted ''if any'' from § 704.5(a)(1) to clarify a corporate must have ''appropriate tests and criteria'' to evaluate investments it makes on an ongoing basis, as well as new investments. No comments were received on these provisions, and they have been retained as proposed.

The revised proposed rule deleted the requirement in § 704.5(a)(2) that the investment policy address the marketing of liabilities to its members. No comments were received on this provision, and it is deleted in the final rule.

The revised proposed rule added a requirement for a corporate to establish appropriate aggregate limits on limited liquidity investments. As with the initial proposed rule, the revised proposed rule defined ''limited liquidity investment'' to mean an investment without a quoted market price. The preamble specified ''limited liquidity investment'' means ''a private placement or funding agreement.'' 67 FR at 44274, 44285.

One commenter did not object to the proposed definition and supported the proposed requirements for limited liquidity investments. Another commenter was concerned with the proposed definition. The commenter noted using the term ''quoted market price'' in the definition was problematic, since sales prices on most ABS and MBS are not publicly available and dealers do not post bid and asked quotes. The Board agrees and has revised the definition in the final rule so that it is consistent with the revised proposed preamble. The final rule limits ''limited liquidity investments'' to private placements and funding agreements. The requirements for limited liquidity investments are retained as proposed.

Authorized Activities, Section 704.5(c)(5). The revised proposed rule clarified an ABS must be domestically issued. No comments were received on this provision, and it is retained as proposed.

Section 704.5(c)(6). The revised proposed rule deleted this section, which provided specific authorization for CMOs. These investments are still authorized under § 704.5(c)(1) and (5). No comments were received on this provision, and it is deleted in the final rule.

Repurchase agreements, Section 704.5(d). The revised proposed rule made several changes to the requirements for repurchase agreements to conform them to current market practices. No comments were received on this provision, and it is retained as proposed.

Securities lending, Section 704.5(e). The revised proposed rule made several nonsubstantive changes to the requirements for securities lending transactions to clarify the rule and conform it more closely to current market practices. No comments were received on this provision, and it is retained as proposed.

Investment companies, Section 704.5(f). Section 704.5(f) of the revised proposed rule allows a corporate to invest in an investment company, for example, a mutual fund ''provided that the prospectus of the company restricts the investment portfolio to investments and investment transactions that are permissible for that corporate credit union.'' One commenter stated that the prospectus of an investment company does not restrict the investment portfolio of an investment company, and suggested that the quoted language be changed to read ''provided that all investments and investment transactions, as described in the prospectus of the company, are permissible for that corporate credit union.'' The Board appreciates the issue

the commenter raises but does not believe a change is necessary.

A mutual fund must file a registration statement with the Securities and Exchange Commission (SEC) on Form N–1A. The prospectus is Part A of Form N–1A. According to the SEC's instructions for completing Part A, the prospectus will ''describe the Fund's principal investment strategies, including the particular type or types of securities in which the Fund principally invests or will invest.'' SEC Final Rule, Registration Form Used by Open-End Management Companies (Item 4), 63 FR 13916, 13951, March 23, 1998.

To the extent that a prospectus for a particular mutual fund only discloses the securities it ''principally'' invests in, the fund might hold other investments that are impermissible for the corporate credit union. This is unacceptable. A corporate may not own investments indirectly through a mutual fund that it is prohibited from owning directly.

While the SEC's instructions on completing a prospectus do not require the prospectus disclose all permissible investment types, the instructions do not prohibit such disclosure either. Where the prospectus' description of investment types includes only investments permissible for corporates, and that it will not hold investments other than those described, the mutual fund will be permissible for the corporate.

The Board also notes that Part B of the registration statement, the Statement of Additional Information (SAI), provides additional information about the mutual fund's investment policies and permissible investment types. For example, the SAI will ''[d]escribe any investment strategies, *including a strategy to invest in a particular type of security,* used by an investment adviser of the [mutual] fund in managing the fund that are *not* principal strategies * * *.'' Final Rule, Registration Form Used by Open-End Management Companies (Item 12(b)), 63 FR 13916, 13956, March 23, 1998, (emphasis added). In addition, the SAI will ''[d]isclose, if applicable, the types of investments that a Fund may make while assuming [a temporary defensive position as described in the prospectus.]'' *Id.,* Item 12(d).

If a prospectus is not clear, a corporate should obtain the SAI on any particular mutual fund directly from the fund company. A fund's prospectus, when read in conjunction with the SAI, should provide sufficient information on the types of investments the fund may make and whether they are restricted to those permissible for the corporate.

Prohibitions, Section 704.5(h). The revised proposed rule permitted trading securities but required transactions to be accounted for on a trade date basis and, in addition, no longer prohibited engaging in pair-off transactions and when-issued trading. The revised proposed rule retained the prohibitions on engaging in adjusted trading and short sales. No comments were received on these provisions and they are retained as proposed in the final rule.

The revised proposed rule prohibited investments in residual interests in ABS, deleted the prohibition on commercial mortgage related securities, and moved the prohibition on the purchase of mortgage servicing rights from the investments section to the permissible services section. The Board notes that the prohibition on the purchase of mortgage servicing rights, as explained in the permissible services section, is being retained as an impermissible investment. One commenter agreed with the deletion of the prohibition on investments in commercial mortgage-related securities. The commenter noted the market for privately-issued commercial mortgage-related securities has become well-established in recent years. The Board agrees, and these provisions have been deleted or amended as proposed.

Credit Risk Management, Section 704.6

The revised proposed rule defined ''obligor'' to mean the primary party obligated to repay an investment and excluded from the definition the originator of receivables underlying an asset-backed security, the servicer of such receivables, or an insurer of an investment. No comments were received on this definition, and it is retained as proposed.

The revised proposed rule deleted the definitions of ''short-term investment'' and ''long-term investment'' since they are no longer used. The revised proposed rule also deleted the definition of ''expected maturity,'' since that term was only used in the definitions of these deleted terms. No comments were received on these definitions, and they are deleted in the final rule.

Policies, Section 704.6(a). The revised proposed rule amended the policy requirements to base credit limits on capital, rather than RUDE and PIC. A few commenters supported this provision. This provision is retained as proposed.

The revised proposed rule deleted the requirement that the credit risk management policy address loan credit limits. The revised proposed rule added to the examples of concentrations of credit risk an ''originator of receivables'' and an ''insurer.'' No comments were received on these provisions, and they are retained as proposed.

Exemption, Section 704.6(b). The revised proposed rule required subordinated debt of government sponsored enterprises to meet the rule's credit risk management requirements. No comments were received on this provision, and it is retained as proposed.

Concentration limits, Section 704.6(c). The revised proposed rule established a general credit concentration limit of 50 percent of capital or a *de minimis* limit of $5 million for the aggregate of all investments in any single obligor, whichever is greater. One commenter, a bank trade group, asserted these changes would increase concentration limits. It claimed without explanation that the proposed 50 percent of capital limit would not have the overall effect of reducing credit concentration limits from the prior limits as stated in the preamble to the proposed rule. 67 FR at 44275. The Board disagrees. Using July 2002 month-end data for an unsecured obligation, the proposed 50 percent of capital limit, in comparison to the current limits, would decrease the corporate system's aggregate maximum investment in the unsecured obligations of a single obligor from $5.43 billion to $2.95 billion, reflecting a reduction in credit concentration of $2.48 billion. For secured obligations, there would be a large reduction because, unlike the revised proposal that had a limit of 50 percent of capital, corporates with Part I or Part II expanded authorities currently have no limitation.

Eleven commenters opposed the general credit concentration limit as too restrictive. Some commenters noted there is a relatively small number of AAA rated obligors. Thus, the proposed limits could force increased aggregate exposure to lower quality credits. A number of these commenters suggested a general credit concentration limit of 100 percent of capital on investments rated no lower than AA- (or equivalent) or A–1 (or equivalent). Two commenters recommended an increase to the credit concentration limit for investments rated AAA (or equivalent); one recommended a limit of 100 percent of capital. One commenter suggested differentiating between single obligor debt instruments and ABS or MBS, noting single obligor instruments, such as corporate debt instruments, are entirely dependent upon the performance of the issuing entity. Two commenters suggested NCUA generally reconsider the limits, with one suggesting NCUA permit a higher

percentage concentration limit for investments rated AA (double A flat) or higher.

As the Board noted in the revised proposed rule, the Board believes this 50 percent limit is the most credit exposure a corporate should prudently take in investment-grade quality investments. *Id.* The Board continues to believe the corporate network must exercise caution in placing membership capital at risk, and these provisions are retained as proposed.

Section 704.6(c)(2) of the revised proposed rule provided exceptions to the general credit concentration rule. For repurchase and securities lending transactions, the proposed limit was 200 percent of capital. Investments in corporate CUSOs were subject to the limitations in § 704.11. Investments in wholesale corporate credit unions and aggregate investments in other corporates were exempt. One commenter recommended limiting the exemption to wholesale corporates. The commenter asserted it was difficult to envision efficiencies for corporates investing in other non-wholesale corporates. As stated in the preamble to the revised proposal, the Board continues to believe that the benefits to the corporate system of applying this exemption to all corporates outweigh any potential concerns, and the Board is retaining the exemption in the final rule. 67 FR at 44275.

Revised proposed § 704.6(c)(3) deems an investment as ''nonconforming'' if it fails a credit concentration requirement because of a reduction in capital following the purchase of that investment. A corporate is required to exercise reasonable efforts to bring nonconforming investments into conformity within 90 days. Investments that remain nonconforming for 90 days are deemed to ''fail'' a requirement, and a corporate will have to comply with the requirements in § 704.10. No comments were received on this provision, and it is retained as proposed.

Two commenters recommended deleting § 704.6(c)(4), since proposed § 704.6(c)(3) addressed the same issue. The Board notes that § 704.6(c)(4) was deleted in the revised proposed rule and will remain deleted in the final rule.

Credit ratings, Section 704.6(d). This section reduced the applicable credit rating to AA- (or equivalent) for investments with long-term ratings and A–1 (or equivalent) for investments with short-term ratings. The revised proposed rule triggered the investment action plan requirements of § 704.10 if at least two ratings were downgraded and a corporate had relied on more than one rating to meet the minimum credit rating requirements at the time of purchase.

A state-chartered corporate supported this proposal, but believed additional investment authority was needed. The corporate noted its state supervisory authority permitted investment in all investment grade categories. Further, the commenter noted typical cash market practice for repurchase transactions is to require investment grade securities; the commenter noted it is more difficult to arrange repurchase agreements at favorable rates if the securities must be restricted to those with ratings in the top grades of the investment grade categories.

As noted in the preamble to the revised proposed rule, in light of the substantial flexibility already provided to corporates, the Board remains convinced a base level corporate should not be permitted to acquire more than limited credit risk exposure. Expanded authority provisions allow a broader spectrum of credit risk, and require increased due diligence by corporates that obtain such authority. 67 FR at 44276. Thus, this section is retained as proposed.

The proposed rule clarified investments in a corporate or a CUSO do not require a rating. One commenter recommended corporates be permitted to invest in other non-wholesale corporates only if that corporate had a credit rating from at least one nationally recognized statistical rating organization (NRSRO). It is not current market practice for corporates to obtain depositor ratings. While an NRSRO rating is a useful tool for investors to evaluate credit risk, it is no substitute for due diligence. The Board is convinced a corporate should be permitted to decide whether to purchase shares or deposits in another corporate. Thus, this provision is retained as proposed.

One commenter requested clarification of ratings relied upon ''at the time of purchase.'' The commenter noted this might mean either the trade or settlement date. The commenter asserted industry practice was to assign an assumed rating for new-issue securities and not to provide an official rating until settlement date. The commenter suggested there was the potential for a corporate to be unable to purchase new-issue securities until settlement date when the official rating was assigned if the interpretation of ''at the time of purchase'' were trade date. The Board agrees industry practice is to assign an assumed rating for new-issue securities and not to provide an official rating until settlement date. However, the Board understands it is also industry practice that purchase offers are contingent on assignment of the assumed rating. This means a purchasing corporate could refuse delivery on the settlement date if a security did not receive the bargained for rating. Thus, ''at the time of purchase'' means the security must have either an official permissible rating on the trade date if purchase is not contingent on receipt of an official permissible rating or, for a new issue, an assumed permissible rating on the trade date and an official permissible rating on the settlement date.

To avoid confusion regarding the investment watch list requirements of § 704.6(e)(1), the revised proposed rule clarified in § 704.6(d)(4) that it is applicable only when the corporate relied upon more than one rating to meet the minimum credit rating requirements at the time of purchase. If there is a subsequent downgrade below the minimum requirement, then the investment must be placed on the investment watch list.

One commenter recommended a technical change in § 704.6(d)(4) to delete the words ''any rating that'' following ''investment watch list'' and to substitute ''any investment for which a rating.'' The Board agrees, and the final rule reflects that substitution.

Reporting and documentation, Section 704.6(e). The revised proposed rule clarified that requirements for annual approval apply to each credit limit with each obligor or transaction counterparty. No comments were received on this provision, and it is retained as proposed.

Lending, Section 704.7

Section 704.7(c)(1) and (2). Currently, the aggregate secured and unsecured loan and line of credit limits to any one member credit union are based on the higher of a percentage of capital or a percentage of RUDE and PIC. The Board proposed basing the loan limits on a percentage of capital and eliminating the option of basing them on a percentage of RUDE and PIC. The Board received no comments on this section and has adopted this change in the final rule.

Section 704.7(c) and (d) and Appendix B to Part 704 reference ''irrevocable'' loans and lines of credit. In the revised proposed rule, the Board deleted the modifier ''irrevocable'' while clarifying in the preamble that the loan and line of credit limits apply to both ''irrevocable'' and ''revocable'' loans and lines of credit. One commenter objected to the deletion of the word ''irrevocable'' in the revised proposed rule. This commenter

suggested re-inserting either ''irrevocable'' or ''committed'' in the final rule so that the limits do not apply to uncommitted lines of credit. The Board's intent is that the aggregate limits apply to all loans and lines of credit and, therefore, the Board is retaining the deletion in the final rule.

Section 704.7(d). This section addresses ''Loans to nonmembers'' and is subdivided into two subsections: Credit unions and Corporate CUSOs. A commenter suggested part 704 should not distinguish between corporate and natural person credit union CUSOs. This commenter recommended expanding § 704.7 to address loans to natural person credit union CUSOs rather than requiring those loans to comply with part 723. The rationale was that the part 723 collateral requirements put corporates at a disadvantage in the marketplace for natural person credit union CUSO related activities. In the final rule, the Board does not expand § 704.7 to address loans to natural person credit union CUSOs. The Board believes that the exceptions should only apply to loan limits for corporate CUSOs because these entities are wholly or partially owned by corporates. Also, loans to corporate CUSOs are currently required to comply with part 723's aggregate limits and most of that regulation's due diligence requirements.

Section 704.7(e)(3). This provision of the revised proposal, like the current rule, provides a partial exemption from the member business loan rule if a loan or line of credit to an ''Other member'' is fully guaranteed by a credit union or fully secured by U.S. Treasury or agency securities. One commenter requested clarification as to whether cash or shares are also included as permissible collateral to secure a loan, line of credit or letter of credit. Loans secured by cash or shares, rather than qualifying for a partial exemption, are not member business loans and, therefore, are not subject to any of the requirements of part 723. 12 CFR 723.1(b)(2).

Revised proposed § 704.7(e) clarified the applicability of the member business loan rule in part 723 to loans granted by a corporate. The Board did not receive any comments on this revision and, therefore, the Board retained this clarification in the final rule.

Revised proposed § 704.7(g) expanded the provision governing loan participations between corporates to include a requirement that a corporate execute a master participation loan agreement before the purchase or the sale of a participation loan. In conjunction with this requirement, the Board deleted the language that a participation loan agreement may be executed at any time before, during, or after the disbursement. No comments were received on this section, and this requirement is retained in the final rule.

The Board proposed allowing corporates to participate in loans with member natural person credit unions but only as an expanded Part V authority and with certain limitations. One commenter indicated proposed Part V authority should be a permissible activity for all corporates. The rationale was that, since natural person credit unions are permitted to engage in this activity, it is not a regulatory concern for NCUA. This commenter also stated that state law on participation lending should govern state-chartered corporates. As stated in the preamble to the proposed rule, since the Board believes ''a number of corporates do not exhibit a level of infrastructure commensurate with the risks associated with this activity,'' corporates should apply for approval before entering into loan participations with natural person credit unions. 66 FR at 48748. For these reasons, the final rule only allows corporates with Part V authority to engage in participation lending with natural person credit unions. These safety and soundness concerns apply to state-chartered corporates as well as federal corporates. Another commenter recommended the Board grandfather corporates who have received a waiver to engage in participation lending with member natural person credit unions. The Board agrees and corporates with existing waivers continue to have the authority to enter into loan participations to the extent previously granted without applying for Part V authority.

One commenter recommended expanding Part V to permit a wholesale corporate to join with its member corporate in participating in a loan that the wholesale corporate is permitted to purchase in its own right from a nonmember natural person credit union. The Board believes it needs additional time to study this issue, which is being raised for the first time in response to the revised proposed rule. The Board notes that, after additional study, it may be open to considering this activity as permissible either by amending the regulation to expand Part V or as a waiver to Part V.

Finally, the Board proposed reorganizing the lending section to make it easier to read. No commenter objected to the reorganization and the final rule incorporates these changes.

Asset and Liability Management, Section 704.8

The revised proposed rule deleted the term ''net interest income'' because it is no longer used in the regulation and amended the definitions of ''net economic value (NEV)'' and ''fair value.'' NEV means the fair value of assets minus the fair value of liabilities. The amended definition excluded from liabilities both PIC and MC, rather than excluding only PIC. One commenter again urged that all off balance sheet financial derivatives remain in the definition of NEV. As the Board explained in the revised preamble, for purposes of NEV measurement, GAAP does not require accounting for immaterial positions in financial derivatives on balance sheets. 67 FR at 44277.

The commenter also recommended limiting the aggregate amount of MC and PIC included in total capital to not more than 100 percent of RUDE in any NEV-related requirements. This would limit the aggregate amount of MC and PIC excluded from liabilities for purposes of NEV calculations to not more than retained earnings, resulting in NEV limits based on a percentage of two times the fair value of retained earnings. If a corporate were to realize a loss of substantially all of retained earnings, but not MC or PIC, the commenter's proposal would require a corporate without net unrealized gains to eliminate all interest rate risk. The Board does not believe this is the most advisable course of action to re-establish earnings. Instead, the Board has proposed conservative NEV limits based on capital, rather than a subset of capital. Under the Board's formulation, a loss of substantially all of retained earnings reduces the level of interest rate risk permitted, but does not require a corporate to eliminate all interest rate risk. Therefore, these provisions are deleted or amended as proposed.

The Board has made a technical change to the revised proposed definition of ''fair value.'' In the first sentence of the definition ''other than in'' is changed to ''as opposed to.''

Policies, Section 704.8(a)(2). The revised proposed rule eliminated the redundancies with § 704.5(a) and changed the term ''current NEV'' to ''base case NEV'' to provide uniform usage throughout the regulation. No commenters addressed these provisions, and they are deleted or modified as proposed.

Section 704.8(a)(5). The revised proposed rule deleted the requirement for a policy limit on decline in net income. One commenter supported this

deletion, and it is deleted in the final rule.

Section 704.8(a)(6). The revised proposed rule added a requirement for the asset and liability management policy to address the tests used before purchase, to include an estimate of the impact of proposed investments on the percentage decline in NEV, as compared to the base case NEV. One commenter opposed this requirement. The commenter advocated the tests should be reviewed as a supervisory issue. As noted in the preamble to the revised proposed rule, this provision is intended to require a corporate to establish an ongoing process to identify, estimate, monitor and control interest rate risk between the periodic complete NEV analyses. 67 FR at 44277. The Board believes a corporate's board should establish policy parameters for this process and has retained this section as proposed.

Penalty for early withdrawals, Section 704.8(c). The revised proposed rule clarified that the minimum penalty for early certificate/share withdrawal, if early withdrawal is permitted, must be reasonably related to the rate that the corporate would be required to offer to attract funds for a similar term with similar characteristics. The preamble noted a gain does not appear consistent with the notion of a penalty for early withdrawal. 67 FR at 44278.

No commenters addressed the text of the revised proposed rule, however, nine commenters objected to the statement in the preamble that a gain does not appear consistent with the notion of a penalty for early withdrawal. *Id.* The commenters asserted a gain could be paid on early withdrawal of a share certificate and still meet the requirement of a penalty for early withdrawal. The commenters noted this is consistent with the ''mark to market'' premise of a penalty sufficient to cover the estimated replacement cost of the redeemed certificate. The commenters also noted the need to be competitive with alternative instruments that could provide members with liquidity and gains, without the need to increase the balance sheet of both the corporate and the member by a share secured loan if a gain could not be paid.

The Board does not believe that the concept of a penalty can be equated with the payment of a gain and reiterates that a gain is not permissible in conjunction with a penalty for early withdrawal. In addition, the Board is concerned that contractual provisions for redemption of a deposit at a gain may have the unintended consequence of encouraging a run on a substantially impaired corporate by members seeking to obtain gains. The Board acknowledges holders of debt securities may freely transact with third-party participants in the secondary market at a price that may result in a gain to the holder. However, debt security issuers typically are not subject to repurchase demands by debt holders. This is because the holder of a typical debt security does not have the right to put the debt to the issuer at a market price.

Interest rate sensitivity analysis, Section 704.8(d). The revised proposal deleted the requirement to conduct net interest income simulations. One commenter supported the elimination of the requirement for net interest income simulations, and it is deleted in the final rule.

The revised proposed rule deleted the word ''Treasury'' to permit evaluation of the impact of shocks in appropriate yield curves on its NEV and NEV ratio, since the market has moved away from the Treasury yield curve as a benchmark. No comments were received on this provision, and it is amended as proposed.

Section 704.8(d)(1)(i). The revised proposed rule increased from two to three percent the minimum base case NEV ratio that triggers monthly interest rate sensitivity analysis testing. One commenter suggested setting the trigger at four percent, rather than three percent, since the base case NEV ratio for most corporates will increase significantly because of the new definition of NEV.

The Board is comfortable with a three percent NEV trigger for monthly testing in base corporates, in large measure because the corporate system has improved its ability to identify, measure, monitor and control interest rate risk since the existing regulation was adopted. In addition, the estimation requirements of amended § 704.8(a)(6) typically provide adequate information for a base corporate with a minimum base case NEV ratio of at least three percent to monitor and control interest rate risk between complete periodic reevaluations. The Board recognizes base case NEV ratios are likely to increase substantially under the amended definition of NEV. The section is retained as proposed.

Section 704.8(d)(1)(ii) limited a corporate's risk exposure to levels that do not result in any NEV ratio resulting from the specified parallel shock tests, or a base case NEV ratio, of less than two percent, rather than the current one percent. No comments were received on this provision, and it is retained as proposed.

Section 704.8(d)(1)(iii). The proposal reduced the NEV decline limit for a base corporate from 18 to 15 percent. This represented an increased level of risk compared to the current rule, since the proposal excluded MCs from liabilities and, therefore, increased the base case NEV.

Two commenters recommended the Board retain the 18 percent limit: one noted this represented little interest rate risk and the other was not aware of any significant deterioration of a base corporate because of interest rate risk. In contrast, one commenter suggested reducing the NEV decline limit to 10 percent, to avoid increasing the amount of interest rate risk permitted.

As noted in the preamble to the revised proposed rule, the Board is comfortable with the increased risk because the corporate system has improved its ability to measure interest rate risk since the existing regulation was adopted. 67 FR at 44278. In addition, the estimation requirements of amended § 704.8(a)(6) provide adequate information for a corporate to monitor and control interest rate risk between complete periodic reevaluations. The Board does not believe it is prudent to increase the amount of interest rate risk that a base corporate may undertake further than the proposed 15 percent decline in NEV. Corporates meeting the requirements for expanded authority provisions are permitted to undertake additional interest rate risk. Thus, this section is retained as proposed.

Section 704.8(d)(2). The revised proposed rule required all corporates to assess annually whether it is appropriate to conduct periodic, additional, interest rate risk tests. These additional tests formerly were triggered based on the level of unmatched embedded options. No comments were received on this provision, and it is retained as proposed.

Regulatory Violations and Policy Violations, Section 704.8(e) and (f). The revised proposed changes were non-substantive, grammatical amendments and also designated the OCCU Director to respond to regulatory violations. No comments were received on these sections, and they are retained as proposed.

Divestiture, Section 704.10

The Board did not propose any changes to this provision; however, because of confusion concerning this provision, the Board proposed retitling it ''Investment Action Plan.'' This change clarifies that divestiture is not the only remedy available under this section. No commenters opposed the title change; however, five commenters objected to the current inclusion of derivative contracts under the

divestiture requirements of this section. They stated that these contracts are not investments and should not be subject to this provision. The commenters noted that these contracts are not freely tradable between third parties, as is the case with traditional investment instruments, and the cost for a corporate to ''unwind'' a derivative contract can be excessive.

The Board has consistently interpreted derivatives as subject to the requirements for investments. 12 CFR parts 703 and 704. Further, the Board believes these transactions should be subject to the requirements for an investment action plan because of the credit risk of the counterparty. Risk mitigation within the contract will have a significant impact on the Board's willingness to allow the corporate to hold instruments where the issuing entity has been downgraded. The Board is aware there are costs involved in unwinding a derivative contract and will review each plan submitted by a corporate weighing the costs of unwinding the derivative versus the risks associated with holding it. In addition, the Board has added clarifying language to Appendix B, Part IV to clarify how § 704.10 applies to derivative contracts. The Board remains convinced that corporates should not be allowed to hold financial contracts or investments from counterparties with excessive levels of credit risk and so will continue to interpret derivatives as investments under this provision. The Board is revising the title as proposed.

Corporate CUSOs, Section 704.11

The revised proposed rule added new due diligence requirements for corporates' loans to corporate CUSOs. These requirements were taken from the member business loan rule. No commenters commented on this provision and the Board is adopting it in the final rule.

The revised proposed rule maintains a limit of 15 percent of capital for investments in corporate CUSOs, increases the aggregate limit for loans and investments to 30 percent of capital, and retains the additional 15 percent for loans that are fully secured. One commenter objected stating the proposal was too limiting. Another commenter suggested clarifying that the 30 percent aggregate limit for loans and investments does not include the additional 15 percent for loans that are fully secured. The Board believes the increased limits strike the appropriate balance between added flexibility and safety and soundness and is retaining them as proposed in the final rule. The Board notes that the 30 percent aggregate limit does not include the additional 15 percent for loans that are fully secured.

The preamble to the revised proposed rule explained that the current audit requirements in § 704.11(d)(3) do not require a separate CPA audit for wholly owned CUSOs. This modification mirrored the practice that is currently permissible for natural person CUSOs. 63 FR 10743, 10747, March 5, 1998. Six commenters suggested that this exemption be stated in the regulation and it also apply to majority owned CUSOs. The Board agrees and the final regulation states that a wholly owned or majority owned CUSO is not required to obtain a separate annual audit if it is included in the corporate's consolidated audit.

Based on a request from six commenters, the revised proposal amended § 704.11(b) so that it mirrors § 712.6 of the natural person CUSO rule. Section 704.11(b) prohibits a corporate from acquiring control directly or indirectly of another ''financial institution'' and § 712.6 prohibits a natural person credit union from acquiring control directly or indirectly of another ''depository financial institution.'' One commenter questioned the authority of the Board to limit ''financial institution'' with the modifier ''depository.'' The Board's long-standing interpretation of financial institution is that it means a deposit taking institution. 51 FR 10353, 10354, March 26, 1986. This interpretation has been reflected in the natural person CUSO rule since 2001 and the Board believes adopting it in the corporate CUSO rule is appropriate. 66 FR 40575, August 3, 2001. This commenter also objected to the current prohibition on a corporate investing in the shares, stocks or obligations of a CUSO that is a financial institution. The commenter notes that this prohibition is broader than either the limitation in the Federal Credit Union (FCU) Act or the natural person CUSO regulation that only prohibit ''acquir[ing] control directly or indirectly'' and do not prohibit ''invest[ing]'' in a financial institution. 12 U.S.C. 1757(7)(I); 12 CFR 712.6. The Board agrees and is deleting this prohibition from the final rule.

The revised proposal clarified that the aggregate limit of § 723.16, the member business loan rule, applies to loans to CUSOs. No comments were received on this clarification and the Board is retaining it in the final rule.

Permissible Services, Section 704.12

The revised proposal listed eight broad categories of permissible financial services for corporates with examples under each category. This was modeled after the broad categories in parts 712 and 721. The Board received no comments on this provision, except as to its applicability to state-chartered corporates, and is retaining it in the final as proposed.

The revised proposal, at the commenters' suggestion, added a provision similar to the provisions in parts 712 and 721 concerning adding new permissible services. It permits corporates to petition the Board to add a new service to § 704.12 and encourages them to seek an advisory opinion from the Office of General Counsel (OGC) on whether a proposed service is already covered by one of the authorized categories before filing a petition. The rule does not require a corporate to come to OGC for an opinion every time it wants to provide a service not specifically listed as an example under a broad category. An opinion from OGC is recommended if there is doubt as to whether a specific service falls within one of the broad categories. In those situations, a corporate that does not consult with OGC runs the risk of engaging in an impermissible activity and being subject to supervisory action. Six commenters objected to or requested clarification on the applicability of this provision to state-chartered corporates. The commenters suggest that, at a minimum, since a state-chartered corporate's authority to engage in an activity is derived from its state statute and not the FCU Act, the appropriate approach for state charters is to request a waiver, rather than a rule change, to add an activity that may be impermissible for federal corporates. The Board would then base its decision to grant or deny the waiver on any safety and soundness concerns it has with the proposed activity. The Board agrees with the commenters and is revising the final rule to reflect a waiver process for state-chartered corporates.

The revised proposal deleted the requirement that services to nonmember natural person credit unions through a correspondent services agreement could only be provided to those natural person credit unions' branch offices in the corporate's geographic field of membership. In addition, the revised proposal clarified that a correspondent services agreement is an agreement between two corporates for one of the corporates to provide services to the members of the other. One commenter reiterated its objection to the clarification that correspondent services can only be provided through an agreement with another corporate credit union. The Board remains committed to the fundamental principle that credit

unions, including corporates, are formed to serve their members and is adopting the requirements in the revised proposal for correspondent services in the final rule.

The revised proposal also moved the current prohibition on the purchase of ''mortgage servicing rights'' from the investment section to this section and renamed it ''loan servicing rights.'' The Board has reconsidered removing this prohibition from the investment section. The Board will retain the prohibition in the investment section to clarify that this is not a permissible investment. It will also include the prohibition in this section. Although this activity is a permissible service for natural person credit unions under limited circumstances, the Board has safety and soundness concerns with corporates engaging in this activity, and will continue to prohibit this service for corporates.

One commenter suggested clarifying that the prohibition on the purchase of loan servicing rights does not apply if a corporate has the authority to purchase loans and the purchase of servicing rights are in conjunction with that purchase. The Board agrees that the purchase of servicing rights in conjunction with the purchase of a loan is not prohibited.

Fixed Assets, Section 704.13

The revised proposal eliminated this section. No commenters commented on this change. Therefore, the revised proposal reflects this change.

Representation, Section 704.14

The revised proposal clarified the meaning of the term ''credit union trade association'' in § 704.14(a) by adding to the regulation the definition of ''credit union trade association'' that was in the preamble to the prior final rule. 59 FR 59357, 59358, November 17, 1994. The thirteen commenters that commented on this clarification objected to adding a definition of ''credit union trade association.'' The commenters erroneously perceived this as a change and stated that it unnecessarily limited the pool of qualified applicants and is not needed in light of the recusal provisions in § 704.14(d). The commenters stated that the restrictive definition ignores the reality that natural person CEOs on corporate boards are often the most active in the credit union community serving multiple roles at the chapter, league and national level. Several of these commenters suggested amending the definition so that it is not so limiting. They suggested only including the state credit union leagues of the state in which the corporate is headquartered. One commenter fails to see how loyalty is divided if the chair serves on the board of an affinity group such as a defense, automotive or educational trade association. This commenter suggests only prohibiting state or multi-state leagues.

The Board continues to believe that the chairman of the board of a corporate should not serve simultaneously as an officer, director or employee of a national credit union trade association. As the Board stated when this provision was originally drafted, ''the chair should be an individual whose loyalty is *in no way divided* between the corporate credit union and a trade association.'' 59 FR 59357, 59358, November 17, 1994 (emphasis added). The Board, however, agrees that the definition is broader than is necessary to accomplish its objective of having a chair ''whose loyalty is in no way divided'' and is deleting from the prohibition ''and their affiliates and service organizations, and local, state, and national special interest credit union associations and organizations.''

The revised proposal amended the requirement in § 704.14(a) that both federal and state-chartered corporates comply with federal corporate bylaws governing election procedures. All corporates will have to comply with § 704.14(a) governing election procedures but state-chartered corporates will not have to comply with federal corporate bylaws. No commenters commented on this amendment. The Board is retaining this change in the final rule.

Wholesale Corporate Credit Unions, Section 704.19

The revised proposed rule eliminated the proposed 1 percent minimum RUDE ratio requirement and replaced it with an earnings retention requirement when the retained earnings ratio falls below 1 percent.

Three commenters addressed the earnings retention requirement. One commenter disagreed with the proposal stating despite the two-tier corporate structure, the earnings retention requirement should be the same as established for retail corporates. This commenter is concerned with the potential for a significant financial crisis in the credit union industry if a wholesale corporate fails. The Board remains convinced a separate wholesale corporate earnings retention requirement is appropriate based upon the corporate system's tiered capital structure.

One commenter expressed concern with the earnings retention requirement being met by either the current month or rolling 3-month calculation. This commenter believes wholesale corporates should be permitted to meet the earnings retention requirement based on a rolling 12-month average as presently permitted for reserve transfers. The Board believes sufficient flexibility for meeting the earnings retention requirement exists by using either the current month or rolling 3-month calculation. The Board notes the OCCU Director may approve a decrease in the earnings retention amount in the rare event a lesser amount is necessary to avoid a significant adverse impact upon a wholesale corporate.

One commenter stated the .15 percent per annum earnings retention requirement when the retained earnings ratio is less than 1 percent and the core capital ratio is less than 3 percent neither considers the tiering of reserves in the corporate system nor the narrow margins necessary for a wholesale corporate to offer competitive investment products. This commenter believes the earnings retention factor should be .10 percent per annum when the retained earnings ratio is less than 1 percent and the core capital ratio is less than 3 percent. The Board is not persuaded by this argument. The Board considers wholesale corporates subject to .15 percent per annum earnings retention requirement to be thinly capitalized. The Board believes wholesale corporates have numerous options available to reduce the earnings retention requirement if the .15 percent per annum earnings retention requirement is too onerous. For example, wholesale corporates can issue additional PIC to increase the core capital ratio to at least 3 percent or they can use off balance sheet activities to shrink their balance sheet.

Two commenters disagreed with the payment of dividend language in revised proposed § 704.19(b)(5) for many of the same reasons commenters opposed the language contained in revised proposed § 704.3(i)(5) for retail corporates. One commenter recommended substituting a notification provision for the current language. The Board agrees and, for the reasons stated in § 704.3, the final rule replaces the limitations on the payment of dividends with notification and restoration plan requirements.

Appendix A to Part 704—Model Forms

The revised proposal added language to the model forms to clarify the treatment of MC and PIC in the event of the merger, liquidation, or charter conversion of a member credit union or the corporate credit union. Six commenters raised objections to the

proposed clarifications. The commenters expressed concern that the additional requirements, rather than being a clarification to the existing language, alter the contractual agreement between the corporate and its members. A number of commenters also noted the additional language might create potential legal, regulatory, and operational problems. One commenter recommended leaving the added language in Appendix A and making the additional disclosure voluntary. Several commenters noted that natural person credit unions are not bound by part 704, nor is a continuing entity in the event of a charter conversion. Further, the commenters contended that, in the case of a liquidation or charter conversion, the member holding the MC or PIC account ceases to exist. As the entity no longer exists, its membership automatically terminates and its shares, including MC and PIC, should be paid out in accordance with applicable law. The commenters argued the model forms conflict with the Corporate Federal Credit Union Bylaws, and they may also conflict with applicable state laws for state-chartered credit unions. Several commenters indicated the existing language was adequate and it should be left up to each corporate to determine how to handle MC in the event of a merger, liquidation, or charter conversion based on its own capital management plan and applicable laws and regulations.

The Board does not believe the language added to Appendix A and to the requirements for MC in § 704.3(b)(3) create any additional legal, regulatory, or operational problems. The current regulation requires all MC accounts to have a minimum three-year notice. 12 CFR 704.2. The regulation does not provide any exceptions to the three-year notice requirement. The clarifying language has been added because OCCU has received inquiries as to how to handle MC in the event of merger, liquidation or charter conversion.

In the event of a merger, the existence of the MC should be identified as part of the due diligence process. The continuing credit union has the right to put the MC on notice. If the continuing credit union is a member of the corporate, an adjusted balance account may be adjusted at the next adjustment period. If the account is not an adjusted balance account, the continuing credit union would not be in violation of § 703.100, as that section specifically states the measure is assets ''*at the time of purchase*'' of the MC. In the event of a charter conversion, as with a merger, the existence and requirements of the MC should be identified during the due diligence leading up to a charter conversion. The new entity may place the MC on notice and collect the funds at the end of the three-year notice period. In the event of a liquidation, the Liquidating Agent may submit a request to the OCCU Director to allow the corporate to release the funds before the end of the three-year notice period.

The existing regulation is very specific that the only means by which a credit union may obtain its funds in an MC account is after the three-year notice or if it sells it to another credit union with the concurrence of the corporate. 12 CFR 704.2. The language was drafted to provide as much ''permanence'' to the three-year accounts as possible so they could be considered as capital. The regulatory requirements in the corporate rule and the contractual provisions of the MC concerning the three-year notice requirement do not conflict with the general provision in the Corporate Federal Credit Union Bylaws governing withdrawal of shares. Article III, Section 5 of the bylaws states a corporate's board may not require a member to give more than 60 days notice of intent to withdraw. This general withdrawal provision is not intended to apply to accounts that the member is contractually obligated to maintain for a period in excess of 60 days. Based on the requirements of current § 704.2, there should be no outstanding MC with conditions that would cause legal, regulatory, or operational concerns due to the addition of the clarifying language.

One commenter suggested revising the wording of § 704.3(b)(5) by changing the words ''credit union'' to ''another member'' to permit one member of the corporate to sell its MC to another member rather than only to a credit union in the corporate's field of membership. The Board concurs with the recommendation and has adopted this change in the final rule.

Appendix B to Part 704—Expanded Authorities and Requirements

In the revised proposed rule the Board proposed changes to: expand permissible credit ratings on investments; permit corporates that pre-commit to a higher level of capital the option of a higher level of interest rate risk; ease the requirements for corporates to participate in risk reducing derivative activities; and permit corporates to participate in loan participations with natural person credit unions. In addition, the revised proposal eliminated the proposed requirement for corporates to update the self assessment plan originally submitted for expanded authority. No comments were received objecting to the removal of this requirement and it is retained as proposed.

Base-Plus

In the revised proposed rule, the Board proposed a maximum NEV decline of 20 percent. Several commenters believed the limit should remain at its current 25 percent level, and one commenter believed the level should be decreased. The Board remains convinced that the proposed level is appropriate given the requirement of monthly NEV analysis. The Board is adopting the limits from the revised proposed rule.

Parts I and II

In the revised proposed rule, the Board proposed NEV decline limits based on capital levels. Several commenters opposed the proposed limits recommending the limits remain at current levels, and one commenter recommended lower levels. The Board has greater confidence in the ability of the corporate credit unions to model their balance sheets accurately; therefore, the limits were proposed at levels where the corporates can manage their balance sheets without taking excessive levels of risk. The Board was not convinced to change the levels either up or down; therefore, the Board is adopting the limits from the revised proposed rule.

The Board will permit any corporate currently approved for Part I or Part II Expanded Authorities to request to lower its NEV decline limit in conjunction with a request to lower its minimum capital requirement from 5 or 6 percent, respectively.

In the revised proposed rule, the Board proposed limits for the aggregate credit exposure to a single obligor at 50 percent of capital. Several commenters objected that the 50 percent of capital general concentration limit was too restrictive, particularly for corporates with expanded authorities. The commenters recommended increasing concentration limits to 100 percent, particularly for long-term instruments rated not lower than AA– and short-term investments rated no lower than A–1. The Board continues to believe this limit is the most credit exposure a corporate should prudently take in investment quality investments.

In the revised proposed rule, the Board established a 300 percent of capital limit for Part I, and 400 percent limit for Part II on aggregate investments in repurchase and securities lending agreements with any one counterparty. Several commenters objected to the

limits stating that these levels will significantly reduce their existing limits. The Board continues to believe the proposed levels are prudent given the secured nature of the activity and the increased requirements for credit analysis for Part I and II corporates; however, the Board believes increasing the limits beyond those proposed would raise safety and soundness concerns. The Board is adopting the limits as proposed in the revised proposed rule.

In the revised proposed rule, the Board tied minimum capital ratings of short-term investments to a minimum issuer long-term rating. One commenter contended that the requirement tying short-term and long-term ratings together is not representative of credit risks in the marketplace because long-term and short-term credit ratings should be assessed independently. The Board remains convinced that the overall credit quality of the issuer must fall within the limits of this rule and is adopting the proposed requirements.

Part II

The Board proposed lowering the minimum credit rating requirement for a long-term investment (including asset-backed securities) to BBB (flat). Three commenters recommended that BBB (flat) concentration limit be reduced to 25 percent and the concentration limit for AAA rated investments be increased to 100 percent of total capital. One commenter recommended the concentration limit for AAA rated investments be set at 75 percent for Part I and 100 percent for Part II. One commenter stated that corporates with higher levels of expanded authority have demonstrated the ability to manage the risks inherent in these lower rated instruments. The commenter also noted that corporates are in the business of managing risk. One commenter was opposed to permitting any investment in BBB (flat) rated securities. Based on the comments and further analysis of the risk, the Board believes the limit for BBB+ and BBB (flat) rated instruments with Part II authority should be reduced from the revised proposed rule level of 50 percent to 25 percent of capital. The Board agrees with the commenters that corporates with Part I or II authority do have additional credit monitoring capabilities allowing them to move down the credit scale and this authority requires the additional infrastructure stipulated in this rule and its appendixes.

Part III

In response to the proposed rule, several commenters noted that Part III granted preference to foreign banks over other foreign counterparties. The revised proposal permitted corporates to purchase investments from any approved entity with an acceptable NRSRO rating within a country with an acceptable country rating. This change allowed corporates greater flexibility in managing their investments. No comments were received and the Board is adopting this change as proposed.

In addition, the revised proposal incorporated the changes from the proposed rule. No comments were received and, for the reasons stated in the revised proposal, the Board is adopting these changes as proposed. 67 FR at 44283.

Part IV

Part IV expanded authorities have been restructured to provide more flexibility among corporates seeking to use derivatives to reduce risk. The current rule requires corporates to have either Part I or II expanded authorities to qualify for Part IV. The proposal removed this requirement. The Board believes that all corporates demonstrating and possessing the resources, knowledge, systems, and procedures necessary to measure, monitor, and control the risks associated with derivative transactions should be permitted to use these powers. As with all expanded authorities, the corporate in its application must detail the specific types of derivatives they may utilize. The Board believes that derivative transactions, used properly, reduce risk to the institution and its members.

In the revised proposed rule, the Board broadened the authority of corporates to enter into derivative transactions by adding government sponsored enterprises, member credit unions, and entities fully guaranteed by an entity with a minimum permissible rating for a comparable term investment. No negative comments were received, and the Board is adopting this change as proposed.

Several commenters noted that the revised proposed rule should state that Part III expanded authority was required for a corporate to enter into derivative contracts with a foreign counterparty. The Board has amended Part IV to clarify this.

In the revised proposed rule, Part IV (b)(1) detailed the requirements for counterparty credit ratings. Several commenters noted in their comments on § 704.10 that derivatives are not investments; therefore Section 704.10 should not apply. As previously stated, the Board has consistently interpreted derivatives as investments for purposes of parts 703 and 704. In addition, the Board believes that without credit mitigation within the contract, these instruments may present excessive levels of credit risk if a counterparty is downgraded. Therefore, Part IV is amended to clarify that compliance with § 704.10 is required if the counterparty is downgraded below permissible levels.

Delegations of Authority

Although not in the initial proposed rule, the Board, in an effort to streamline the regulatory approval process, has delegated to the OCCU Director in the revised proposal, the authority to act on its behalf in § § 704.3(e), (g) and (i); 704.8(e); 704.10; 704.15; and 704.19(b).

Technical Correction

The Board has revised the wording in § 704.18(e) to conform to the new terminology in part 704.

C. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact any proposed regulation may have on a substantial number of small entities (those under $1 million in assets). The rule only applies to corporates, all of which have assets well in excess of $1 million. The final amendments will not have a significant economic impact on a substantial number of small credit unions and, therefore, a regulatory flexibility analysis is not required.

Paperwork Reduction Act

NCUA has determined that the final regulation does not increase paperwork requirements under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget. NCUA currently has OMB clearance for part 704's collection requirements (OMB No. 3133–0129).

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. The executive order states that: ''National action limiting the policymaking discretion of the states shall be taken only where there is constitutional and statutory authority for the action and the national activity is appropriate in light of the presence of a problem of national significance.'' The risk of loss to federally insured credit

unions and the NCUSIF caused by actions of corporates are concerns of national scope. The final rule will help assure that proper safeguards are in place to ensure the safety and soundness of corporates.

The rule applies to all corporates that accept funds from federally insured credit unions. NCUA believes that the protection of such credit unions, and ultimately the NCUSIF, warrants application of the proposed rule to all corporates, including nonfederally insured. The rule does not impose additional costs or burdens on the states or affect the states' ability to discharge traditional state government functions. NCUA has determined that this rule may have an occasional direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. However, the potential risk to the NCUSIF without the final changes justifies them.

The Treasury and General Government Appropriations Act, 1999—Assessment of Federal Regulations and Policies on Families

The NCUA has determined that this rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105–277, 112 Stat. 2681 (1998).

Agency Regulatory Goal

NCUA's goal is to promulgate clear and understandable regulations that impose minimal regulatory burden. The regulatory change is understandable and imposes minimal regulatory burden. NCUA requested comments on whether the proposed rule was understandable and minimally intrusive if implemented as proposed. No comments were received.

Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (Pub. L. 104–121) provides generally for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by Section 551 of the Administrative Procedure Act. 5 U.S.C. 551. The Office of Management and Budget is reviewing whether this rule is a major rule for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996.

List of Subjects

12 CFR Part 703

Credit unions, Investments.

12 CFR Part 704

Credit unions, Reporting and recordkeeping requirements, Surety bonds.

By the National Credit Union Administration Board on October 17, 2002.

Becky Baker,

Secretary of the Board.

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 722

Federal Credit Unions; Miscellaneous Technical Amendment

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final rule.

SUMMARY: The National Credit Union Administration (NCUA) is amending its appraisal regulation regarding the transaction value for nonresidential loans that require an appraisal from a state-certified appraiser. This amendment is technical rather than substantive.

DATES: This rule is effective November 4, 2002.

FOR FURTHER INFORMATION CONTACT: Chrisanthy J. Loizos, Staff Attorney, Division of Operations, Office of General Counsel, (703) 518–6540, National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314–3428.

SUPPLEMENTARY INFORMATION: When adopting the Regulatory Flexibility Program in 2001, NCUA amended its appraisal rule to raise the threshold for requiring an appraisal for real estate-related financial transactions from those over $100,000 to those over $250,000. 66 FR 58656, 58662, Nov. 23, 2001. NCUA also removed the provision creating a different threshold for appraisals related to member business loans. *Id.* The amendment, therefore, raised the appraisal threshold for all real estate-related financial transactions, including member business loans, to $250,000. The NCUA Board found that the raised appraisal threshold for a member business loan was consistent with the regulatory provisions adopted by the Federal banking agencies.

In the 2001 rulemaking, NCUA amended the transaction value threshold in paragraph (a)(1), the paragraph that requires certain types of transactions to have appraisals. 12 CFR 722.3(a). NCUA did not adjust the corresponding amount in paragraph (b)(2), the paragraph that determines the type of appraiser for certain nonresidential transactions, namely, member business loans. 12 CFR 722.3(b)(2). This has caused some confusion. Under paragraph (b)(2), only nonresidential transactions with a transaction value over $250,000 require an appraisal by a state-certified appraiser. 12 CFR 722.2(e), 722.3(a)(1), 722.3(b)(2). Some credit unions, however, have read the requirement in paragraph (b)(2) as requiring an appraisal for transactions with a value over $50,000.

This amendment conforms the transaction value that triggers the requirement for a state-certified appraiser's appraisal in paragraph (b)(2) to the transaction value threshold in paragraph (a)(1), which initially determines if the rule requires any appraisal. The amendment clarifies that a federally insured credit union must have an appraisal prepared by a state-certified appraiser for a nonresidential transaction if the value of the transaction exceeds $250,000.

Regulatory Procedures

Final Rule Under the Administrative Procedure Act

The amendment to the final rule is technical rather than substantive. NCUA finds good cause that notice and public comment are unnecessary under sec. 553(b)(B) of the Administrative Procedure Act (APA), 5 U.S.C. 553(b)(B).

Effective Date

NCUA also finds good cause to dispense with the 30-day delayed effective date requirement under sec. 553(d)(3) of the APA. The rule is technical rather than substantive. The rule will, therefore, be effective immediately upon publication of this notice.

Regulatory Flexibility Act

An initial regulatory flexibility analysis under the Regulatory Flexibility Act is required only when an agency is required to publish a general notice of proposed rulemaking for any proposed rule. 5 U.S.C. 603. As noted previously, NCUA has determined that it is unnecessary to publish a notice of proposed rulemaking for this rule. Accordingly, an initial regulatory analysis is not required. Moreover, since this final rule imposes no new requirements and makes only a technical amendment, NCUA has determined and certifies that this rule will not have any significant economic impact on a substantial number of small credit unions (primarily those under $1 million in assets).

Small Business Regulatory Enforcement Fairness Act

Title II of the Small Business Regulatory Enforcement Fairness Act (SBREFA) of 1996 (Pub. L. 104–121) provides, generally, for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by Section 551 of the Administrative Procedures Act. 5 U.S.C. 551. The Office of Management and Budget has reviewed this rule and has determined that for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 it is not a major rule.

Paperwork Reduction Act

NCUA has determined that the final rule does not increase paperwork requirements under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*) and regulations of the Office of Management and Budget.

Executive Order 13132 Statement

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. NCUA has determined that this final rule does not constitute a policy that has federalism implications for purposes of the executive order.

List of Subjects in 12 CFR Part 722

Credit unions, Mortgages, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on October 15, 2002.

Becky Baker,

Secretary of the Board.

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 702, 741 and 747

Prompt Corrective Action

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final rule.

SUMMARY: Pursuant to Congressional mandate, the National Credit Union Administration (NCUA) adopted a comprehensive system of prompt corrective action consisting of minimum capital standards and corresponding remedies to restore the net worth of federally-insured credit unions. After six quarters of implementation, the NCUA Board issued a proposed rule consisting of revisions and adjustments intended to improve and simplify the system of prompt corrective action. As revised to reflect public comments, the NCUA Board now issues a final rule incorporating these improvements.

DATES: Effective January 1, 2003.

FOR FURTHER INFORMATION CONTACT: *Legal:* Steven W. Widerman, Trial Attorney, Office of General Counsel, National Credit Union Administration, 1775 Duke St., Alexandria, VA 22314. Telephone: 703/518–6557; *Technical:* Jon Flagg, Loss/Risk Analysis Officer, Office of Examination and Insurance, at the address above. Telephone: 703/518–6378.

SUPPLEMENTARY INFORMATION:

The following acronyms are used throughout:

CUMAA Credit Union Membership Access Act
DSA Discretionary Supervisory Action
MBL Member Business Loan
MSA Mandatory Supervisory Action
NWRP Net Worth Restoration Plan
OCA Other Corrective Action
PCA Prompt Corrective Action
RBNW Risk-Based Net Worth
RBP Revised Business Plan
RMC Risk Mitigation Credit

Throughout the Supplementary Information section, citations to part 702 refer to the current version of 12 CFR 702 *et seq.* (2002) and are abbreviated to the section number only.

A. Background

1. Development of Part 702

In 1998, Congress enacted the Credit Union Membership Access Act (''CUMAA''), Pub. L. 105–219, 112 Stat. 913 (1998). CUMAA amended the Federal Credit Union Act (''the Act'') to require NCUA to adopt by regulation a system of ''prompt corrective action'' (''PCA'') consisting of minimum capital standards and corresponding remedies to improve the net worth of federally-insured ''natural person'' credit unions. 12 U.S.C. 1790d *et seq.* In February 2000, the NCUA Board adopted part 702 and subpart L of part 747, establishing a comprehensive system of PCA that combines mandatory supervisory actions prescribed by statute with discretionary supervisory actions developed by NCUA, all indexed to five statutory net worth categories. 65 FR 8560 (Feb. 18, 2000).

Subpart A of part 702 consists of standards for calculating a credit union's net worth and classifying it among five statutory net worth categories. 12 CFR 702.101–108. Also included in subpart A is a separate risk-based net worth (''RBNW'') component that applies to non-''new'' credit unions, § 702.102(a)(1)–(2), that satisfy minimum RBNW and asset size requirements, § 702.103, and whose portfolios of assets and liabilities carry above average risk exposure. § 702.104; 65 FR 44950 (July 20, 2000). Subpart B combines mandatory and discretionary supervisory actions indexed to the five categories, as well as PCA-based conservatorship and liquidation. §§ 702.201–206. Subpart C consists of a system of PCA for ''new'' credit unions. §§ 702.301–307. Subpart D prescribes reserve accounts, requirements for full and fair disclosure of financial condition, and prerequisites for paying dividends consistent with the earnings retention requirement in subpart B. §§ 702.401–403. In addition to these substantive provisions, subpart L of part 747 established an independent review process allowing affected credit unions and officials to challenge PCA decisions. 12 CFR 747.2001 *et seq.* (2000).

Part 702 and subpart L of part 747 were effective August 7, 2000, and first applied to activity in the fourth quarter of 2000 as reflected in the Call Report for that period. The RBNW component of part 702 was effective January 1, 2001, and first applied (for quarterly Call Report filers) to activity in the first quarter of 2001 as reflected in the Call Report for that period.[1]

At the conclusion of the initial PCA rulemaking process, the NCUA Board directed the ''PCA Oversight Task Force'' (a working group consisting of NCUA staff and State regulators) to review at least a full year of PCA implementation and recommend necessary modifications. 65 FR at 44964. This final rule is the result of those recommendations, as modified to reflect public comments. The final rule takes effect January 1, 2003, and first applies to activity in the first quarter of 2003 as reflected in the Call Report for that period.

2. Where Credit Unions Stand Today

a. *Net worth classification.* As of June 30, 2002, federally-insured credit unions are classified as follows within the PCA net worth categories:

[1] Part 702 has since been amended twice—once to incorporate limited technical corrections, 65 FR 55439 (Sept. 14, 2000), and once to delete sections made obsolete by the adoption of a uniform quarterly schedule for filing Call Reports regardless of asset size. 67 FR 12459 (March 19, 2002).

TABLE A -- NET WORTH CLASSIFICATION OF NON-"NEW" FICUS

Statutory net worth category	*Net worth ratio*	*# of non-"new" FICUs*	*Percent of all non-"new" FICUs*
"Well Capitalized"	7% or greater	9382	96.49%
"Adequately Capitalized"	6% to 6.99%	231	2.38%
"Undercapitalized"	4% to 5.99%	83	0.85%
"Significantly Undercapitalized"	2% to 3.99%	17	0.17%
"Critically Undercapitalized"	Less than 2%	10	0.10%

TABLE B -- NET WORTH CLASSIFICATION OF "NEW" FICUS

"New" net worth category	*Net worth ratio*	*# of "new" FICUs*	*Percent of all "new" FICUs*
"Well Capitalized"	7% or greater	45	49.45%
"Adequately Capitalized"	6% to 6.99%	12	13.19%
"Moderately Capitalized"	3.5% to 5.99%	20	21.98%
"Marginally Capitalized"	2% to 3.49%	8	5.49%
"Minimally Capitalized"	0% to1.99%	7	7.69%
"Uncapitalized"	Less than 0%	2	2.20%

b. *RBNW requirement.* As of June 30, 2002, 448 federally-insured credit unions—4 percent of the total—were required to meet an RBNW requirement. Of these, 446 met the requirement using the ''standard calculation.'' § 702.106. The two that failed under the ''standard calculation'' succeeded in meeting their RBNW requirements using the ''alternative components.'' § 702.107. To date, no credit union has completely failed its RBNW requirement, and no credit union has applied for a ''risk mitigation credit.'' § 702.108.

3. Comments on Proposed Rule

On June 4, 2002, NCUA issued a proposed rule consisting of revisions and adjustments intended to improve and simplify the system of PCA. 67 FR 38431 (June 4, 2002). By the close of the comment period for the proposed rule, August 5, 2002, NCUA received 26 comment letters. Comments were received from seven federal credit unions, four state credit unions, eight state credit union leagues, two credit union industry trade associations, an association of state credit union supervisors, two banking industry trade associations, and a Federal Home Loan Bank. Nearly all of the comments supported the series of proposed revisions and adjustments to part 702.

This rulemaking will not address the few comments that suggested modifications to part 702 that exceed the scope of NCUA's statutory authority or that are completely unsupported. Comments on the concept of ''safe harbor'' approval of a net worth restoration plan are addressed in a separate proposed rule found elsewhere in this volume of the **Federal Register**. All other comments are analyzed generally in section B. below.

B. Section-by-Section Analysis of Final Rule

Part 702 ~~P~~rompt Corrective Action

1. Section 702.2—Definitions

a. *Dividend.* Subpart D of part 702 sets various restrictions and requirements regarding the payment of dividends to members. § § 702.403, 702.401(d), 702.402(d)(5). To extend these restrictions and requirements to interest that many State-chartered credit unions pay on shares and deposits, the proposed rule introduced a definition of ''dividend'' that included ''a payment of interest on a deposit by a State-chartered credit union.'' 67 FR at 38433. While one commenter supported the definition as proposed, two others pointed out that State-chartered credit unions pay interest on non-share deposits pursuant to a contractual obligation, and that restricting the payment of interest would cause a credit union to breach its deposit contract with the member. By comparison, dividends paid on shares entail no such contractual obligation. NCUA concurs with the commenters' point. Accordingly, the final rule omits the proposed definition of ''dividends'' and, further, eliminates the reference to ''interest'' in the discretionary supervisory action (''DSA'') restricting the payment of dividends. § § 702.202(b)(3), 702.203(b)(3), 702.204(b)(3). As a result, the term ''dividends'' as used in part 702 excludes only those payments on shares and deposits that meet a statutory or other legal definition of contractual interest, regardless of the label a credit union gives to such payments.

b. *Senior executive officer.* Part 702 neglected to define who is a ''senior executive officer'' for purposes of the DSAs that authorize dismissing ''a director or senior executive officer,'' § § 702.202(b)(7), 702.203(b)(8), 702.204(b)(8); hiring of a ''qualified senior executive officer,'' § § 702.202(b)(8), 702.203(b)(9), 702.204(b)(9); and limiting compensation paid to a ''senior executive officer,'' § § 702.203(b)(10), 702.204(b)(10). *See also* 12 CFR 747.2004(a) (review of dismissal of senior executive officer). To correct this oversight, NCUA proposed incorporating by reference the definition of a ''senior executive officer'' in 12 CFR 701.14(b)(2). 67 FR at 38433. Apart from a misquotation in the preamble to the proposed rule, the sole commenter supported the proposed definition. Accordingly, the final rule adds a new subsection (i) to § 702.2 that

incorporates by reference the definition of ''senior executive officer'' in 12 CFR 701.14(b)(2).

c. *Total assets.* The ''average quarterly balance'' definition of ''total assets'' was ambiguous as to whether the phrase ''[t]he average of quarter-end balances of the four most recent calendar quarters,'' § 702.2(j)(1)(i), refers to the four consecutive quarters *preceding* the then-current quarter, or to the then-current quarter *plus* the preceding three consecutive quarters. The proposed rule revised the definition to adopt the latter meaning. 67 FR at 38433. Apart from a misquotation in the preamble to the proposed rule, the two comments on the definition favored the latter meaning. Accordingly, the final rule redefines the ''average quarterly balance'' as the average of quarter-end balances of ''the current and three preceding calendar quarters.'' In addition, the final rule deletes the reference to semiannual first and third quarter Call Reports from the ''quarter end balance'' definition of ''total assets,'' § 702.2(l)(1)(iv), to reflect the adoption of a uniform quarterly schedule for filing Call Reports. 67 FR 12457 (March 19, 2002).

2. Section 702.101—Measures and Effective Date of Net Worth Classification

For nearly all credit unions, the effective date of net worth classification is the ''quarter-end effective date''—''the last day of the calendar month following the end of the calendar quarter.'' § 702.101(b)(1). Occasionally, however, an interim effective date between quarter-ends applies instead because ''the credit union's net worth ratio is recalculated by or as a result of its most recent final report of examination.'' § 702.101(b)(2). This typically results when an NCUA examination that takes place after the quarter-end effective date discloses that the credit union erred in calculating its net worth ratio and the corrected ratio puts it in a different net worth category. In that case, the date the credit union receives the final examination report becomes the new effective date of classification to the proper net worth category.

Several flaws have made it difficult to implement subsection (b)(2). First, it extended to instances where there was no error or misstatement in calculating net worth, but rather, data or conditions simply had changed since the date of the Call Report (which would be reflected in the next quarter's Call Report). Second, notice to the credit union to correct its net worth ratio had to await the ''most recent report of final examination'' even when an earlier supervision contact disclosed a calculating error or misstatement. Third, postponing such notice may deprive the credit union of the opportunity to take corrective action sooner. To rectify these flaws, the proposed rule revised subsection (b)(2) to define the effective date of classification to a ''corrected net worth category'' as ''the date the credit union receives subsequent written notice . . . of a decline in net worth category due to correction of an error or misstatement in the credit union's most recent Call Report.'' 67 FR 38434. NCUA received three comments on this section, all favoring these revisions. Therefore, the final rule adopts them as proposed.

3. Section 702.106—Standard Calculation of RBNW Requirement

The proposed rule suggested no modifications to the standard component for ''member business loans outstanding'' (''MBLs''). § 702.106(b). However, one commenter contended that the 12.25 percent risk-weighting threshhold in that component was arbitrarily based on CUMAA's restriction on member business lending, 12 U.S.C. 1757a(a)(2), and proposed that the threshhold be increased to 25 percent. After considering this suggestion, the NCUA Board has determined that the existing 12.25 percent threshold warrants reconsideration in connection with its review of the current MBL regulation, 12 CFR 723. Pending reconsideration, a credit union has two alternatives if it finds that the 12.25 percent threshhold distinguishes risk weightings among MBLs imprecisely. First, to resort to the corresponding alternative component for MBLs, § 702.107(b), which measures finer increments of risk among fixed- and variable rate MBLs. And second, to seek a risk mitigation credit, § 702.108, to moderate the impact of the standard risk-weightings. Accordingly, the existing 12.25 percent threshold is retained at this time.

4. Section 702.107—Alternative Components for Standard Calculation

a. *Alternative component for long-term real estate loans callable in 5 years or less.* For long-term real estate loans, part 702 features both a ''standard component'' and an ''alternative component'' for the RBNW calculation. § § 702.106(a), 702.107(a). The longer the maturity of the loan, the greater the interest rate risk and credit risk exposure, justifying a correspondingly greater risk-weighting. *See* 65 FR at 44960–44961. Both components scheduled loans by contractual maturity date regardless whether there is a ''call'' feature permitting the lender to redeem the loan before the maturity date. The NCUA Board declined to propose scheduling ''callable'' loans by ''call'' date, rather than by maturity date, for reasons explained in the proposed rule. 67 FR at 38435. Instead, the NCUA Board suggested than an offsetting risk mitigation credit under § 702.108 was well suited to recognize when a credit union's program and history of efficiently exercising ''call'' options truly mitigates risk.

Six commenters objected that the NCUA Board's position denies them a reduced risk-weighting even though a ''call'' feature gives them the flexibility to shorten the term of real estate loans, thereby mitigating interest rate risk, and credit risk due to deterioration of the borrower's ability to repay or the collateral's value. One commended the ''call'' feature as a risk management tool. Another advocated allowing use of the ''call'' date, in lieu of the maturity date, on a credit union-by-credit union basis. And finally, a commenter recommended categorizing ''callable'' and non-''callable'' loans separately and assigning lower risk weightings to the ''callable'' category to reflect its reduced interest rate risk. In light of these comments, the NCUA Board has reconsidered its position and now recognizes that a ''call'' feature, when exercised in good faith, provides some measure of risk mitigation for real estate loans.[2]

Accordingly, the final rule expands the existing alternative component for ''long-term real estate loans'' to add a separate schedule for loans that are ''callable'' within a maximum period of 5 years. § 702.107(a)(2). The schedule consists of three maturity buckets that correspond to the buckets in the non-''callable'' schedule. *See* new Table 5(a) and new Appendixes C in rule text below. A loan that is ''callable'' within 5 years, and that has remaining maturity of less than 5 years, receives the same six percent risk-weighting that the existing alternative component gives to a non-''callable'' loan with a remaining maturity of less than 5 years. A loan that is ''callable'' within 5 years, and that has a remaining maturity of more than 5 years, receives a risk weighting that is two percentage points lower than the weighting for the corresponding non-''callable'' maturity bucket. To qualify

[2] The alternative component for MBLs continues to categorize MBLs by fixed- and variable-rate and then schedules the loans in each category for risk-weighting by remaining maturity. § 702.107(b). The NCUA Board is not scheduling MBLs by ''call'' date at this time out of concern for credit risk upon exercise of the ''call'' feature. However, this issue also may receive further consideration in connection with NCUA's review of the current MBL regulation, 12 CFR.

for the ''callable'' schedule, the ''call'' feature must be contractually specified in the loan documents and the credit union must maintain records documenting the breakdown of ''callable'' loans by maturity bucket.

b. *Alternative component for loans sold with recourse.* The standard component for loans sold with recourse assigns a uniform risk-weighting of 6 percent to the entire balance, § 702.106(f), regardless whether it includes loans sold with only *partial* recourse against the seller. Since part 702 was adopted, recourse loan activity among credit unions has nearly doubled, and loan programs have emerged that contractually limit the extent of the purchaser's recourse to the seller.[3] Thus, credit unions have gained the ability to cap their credit risk exposure from the sale of recourse loans.

In view of these developments, the proposed rule added a fourth alternative component to § 702.107 that would allow variable risk-weighting according to the actual credit risk exposure of loans sold with a contractual recourse obligation of less than 6 percent. 67 FR at 38434. The proposed alternative component is the sum of two risk-weighting buckets. The first bucket consists of the balance of loans sold with contractual recourse obligations of six percent or greater; it is risk-weighted at a uniform six percent. § 702.107(d)(1). The second bucket consists of the balance of loans sold with contractual recourse obligations of less than six percent; it is risk-weighted according to the weighted average recourse percent of its contents, as computed by the credit union.[4] § 702.107(d)(2); *see* new Table 5(d) and new Appendixes F and G in rule text below. Eight comments addressed the proposed ''alternative component'' for loans sold with recourse, all supporting it. Therefore, the final rule adopts the new alternative component in § 702.107(d) as proposed.

c. *Alternative component for short-term government obligations.* Although the proposed rule did not reference government obligations, a single commenter proposed an alternative component for government obligations with maturity of one year or less. Under the proposal, these obligations, up to a total equivalent to 25 percent of a credit union's total assets, would receive a zero risk weighting. The NCUA Board is unsympathetic to this proposal because the existing standard component for ''investments'' gives a risk-weighting of three 3 percent-half the six percent risk weighting assigned to average risk assets—to government obligations with a maturity of one year or less. § 702.106(c)(1). Government obligations are not completely risk free, as a zero risk-weighting suggests. On the contrary, they carry interest rate risk and transaction risk that justify a three percent risk weighting. Accordingly, the commenter's proposal is not adopted.

5. Section 702.108—Risk Mitigation Credit

Part 702 permits a credit union that fails an applicable RBNW requirement under both the ''standard calculation'' and the ''alternative components'' to apply for a ''risk mitigation credit'' (''RMC''). § 702.108(a). If granted, an RMC will reduce the RBNW requirement that must be met.[5] But NCUA will not consider an application for this relief until after the effective date that a credit union fails its RBNW requirement. *Submission Guidelines* § I.3. This forces a failing credit union to remain classified ''undercapitalized'' while its RMC application is pending, *id.* § § I.4, I.8, even when it reasonably expects to fail because it either failed or barely passed in a preceding quarter.

To spare credit unions that are genuinely in danger of failing an RBNW requirement from the ''fail first'' prerequisite, the proposed rule allowed them to apply for an RMC preemptively—that is, to apply in advance of the quarter-end so that the credit union receives any RMC for which it qualifies *before* the approaching effective date when it would fail its RBNW requirement. 67 FR at 38434. As revised, § 702.108 would allow a credit union to apply for an RMC at any time before the next quarter-end effective date if on any of the current or three preceding effective dates of classification it has either failed an applicable RBNW requirement, or met it by less than 100 basis points. An RMC granted preemptively would allow a credit union genuinely at risk of failing an RBNW requirement to seamlessly maintain its initial classification as either ''adequately capitalized'' or ''well capitalized.'' The nine commenters who addressed this endorsed the proposed relaxation of the RMC application prerequisites. Therefore, the final rule adopts the revisions to § 702.108 as proposed.

6. Section 702.201—PCA for ''Adequately Capitalized'' Credit Unions

a. *Earnings retention.* The proposed rule identified two flaws in the operation of the quarterly earnings retention requirement that applies to credit unions classified ''adequately capitalized'' or lower. First, that subsection (a) failed to specify that it is the dollar amount of net worth that must increase by the equivalent of 0.1 percent of assets per quarter, not the net worth ratio itself. (Changes in the net worth ratio will not match changes in the dollar amount of net worth unless net worth and total assets were to increase or decrease by exactly the same percentage.) Second, that subsection (a) technically does not allow credit unions to meet the statutory annual minimum transfer of the equivalent of 0.4 percent of total assets *on an average basis* over four quarters. As originally written, that subsection requires that the equivalent of 0.1 percent of assets be set aside in each and every quarter of the year, regardless whether the credit union has set aside more than the quarterly minimum in prior quarters.

To address both flaws, the proposed rule revised subsection (a) to specify that it is the ''the dollar amount'' of net worth that must be increased, not the net worth ratio itself, and to permit the minimum increase to be made ''either in the current quarter, or on average over the current and three preceding quarters.'' None of the commenters addressed these revisions. Therefore, the final rule adopts them as proposed.

b. *Decrease in retention.* Subsection (b) authorized NCUA, on a case-by-case basis, to permit a credit union to increase net worth by an amount that is less than the quarterly minimum (equivalent of 0.1 percent of assets) when necessary to avoid a significant redemption of shares and to further the purpose of PCA. § 702.201(b); 12 U.S.C. 1790d(e)(2). Since the adoption of part 702, however, some credit unions have decreased their quarterly earnings retention, either without seeking NCUA's permission at all, or prior to seeking NCUA's permission, in order to

[3] For example, documentation for the loan sale transaction may provide for recourse in the form of a contractually-specified recourse obligation measured either by a designated dollar amount that is fixed for the life of the loan, or by a designated percentage of the unpaid balance of a pool of loans.

[4] To caluate the ''weighted average recourse percent'' of the bucket of loans sold with recourse <6%, multiply each percentage of contractual recourse obligation by the corresponding balance of loans sold with that recourse to derive the total dollars of recourse. Divide the total dollars of recourse by the total dollar balance of loans sold with <6% recourse to derive the alternative risk weighting. *See* Appendix G in rule text below.

[5] To aid credit unions seeking a ''Risk Mitigation Credit,'' NCUA has released two publications: *Guidelines for Submission of an Application for PCA ''Risk Mitigation Credit''* (NCUA form 8507) *(''Submission Guidelines'')* and *Guidelines for Evaluation of an Application for PCA ''Risk Mitigation Credit''* (NCUA for 8508). The *Submission Guidelines* will be modified to reflect the revisions to § 702.108 adopted in this final rule.

pay dividends as they deem necessary. To prevent unilateral decreases in earnings retention, the proposed rule revised subsection (b) to add the requirement that a request to decrease earnings retention must be submitted in writing no later than 14 days before the quarter end. NCUA would be under no obligation to grant applications submitted after the 14-day deadline expires or after the quarter-end. Further, NCUA would be entitled to take supervisory or other enforcement action against credit unions that either decrease their earnings retention without permission, or persist in failing to timely apply for permission.

Two commenters advocated a more flexible approach—making the application period negotiable, and accepting verbal applications after the deadline, both on a case-by-case basis. The NCUA Board continues to believe that a documented request submitted within a ''bright line'' time frame is necessary for two reasons. First, to give credit unions clear notice of when they must apply for a decrease. Second, to facilitate uniform discipline of credit unions that unilaterally pay dividends without advance permission to decrease their earnings retention. A third commenter objected that a request to decrease earnings retention should not be required when a credit union is operating under an approved net worth restoration plan (''NWRP'') that projects quarterly earnings retention that is less than the minimum. *See* § 702.206(c)(1)(ii). In fact, a separate request for a decrease is not required under these circumstances because, as explained below, earnings retention is effectively subject to quarterly evaluation as a function of the NWRP. For these reasons, the final rule adopts the revisions to subsection (b) as proposed.

c. *Decrease by FISCU.* The requirement to ''consult and seek to work cooperatively'' with State officials when deciding whether a State-chartered credit union may decrease its earnings retention was originally located in § 702.205(c), where it was misidentified as a DSA. Because § 702.205(c) applies only to DSAs, the final rule relocates the ''consult and work cooperatively'' requirement to a new subsection (c) of § 702.201.

d. *Periodic review.* Part 702 provides that a decision permitting a decrease in earnings retention is ''subject to review and revocation no less frequently than quarterly.'' § 702.201(b); 12 U.S.C. 1790d(e)(2)(B). In practice, the ''no less frequently than quarterly'' timetable is too vague to indicate when such a review must take place. To coincide with the quarterly Call Reporting schedule that drives part 702, the proposed rule added a new subsection (d) to require uniform ''quarterly review and revocation,'' except when a credit union classified ''undercapitalized'' or lower is operating under an approved NWRP. NCUA received no comments on this modification.

For ''adequately capitalized'' credit unions (for whom earnings retention is the only MSA), quarterly review is implicit because a request to decrease earnings retention already must be renewed on a quarter-by-quarter basis. However, for credit unions classified ''undercapitalized'' or lower, separate quarterly review would be redundant when an approved NWRP is in place. To be approved, an NWRP must, in addition to prescribing quarterly net worth targets, § 702.206(c)(1)(i), project the amount of earnings retention, decreased as permitted by NCUA, for each quarter of the term of the NWRP. § 702.206(c)(1)(ii). Typically, approved NWRPs permit decreases in earnings retention extending for successive quarters over the term of the plan. These decreases are effectively subject to quarterly review and revocation as a function of the NWRP. A credit union that falls to a lower net worth category because it failed to implement the steps or to meet the quarterly net worth targets in its NWRP may be required to file a new NWRP, § 702.206(a)(3), thereby revoking the then-current NWRP approving future decreases in earnings retention. *See also* 12 CFR 747.2005(b)(3) (civil money penalty for failure to implement NWRP). In contrast, when a credit union *is* implementing the prescribed steps and meeting its net worth targets, there likely would be no reason to discontinue the decreased earnings retention approved in its NWRP.

Because quarterly review is effectively built-in to the NWRP, proposed new subsection (d) exempted credit unions operating under an NWRP from the quarterly review that § 702.201 imposes on ''adequately capitalized'' credit unions. NCUA received no comments on this exemption. Accordingly, the final rule adopts new subsection (d) as proposed.

7. Section 702.204—PCA for ''Critically Undercapitalized'' Credit Unions

a. *''Other corrective action''.* When a credit union becomes ''critically undercapitalized'' (net worth ratio <2%), part 702 gives the NCUA Board 90 days in which to either place the credit union into conservatorship, liquidate it, or impose ''other corrective action * * * to better achieve the purpose of [PCA].'' 12 U.S.C. 1790d(i)(1); § 702.204(c)(1). NCUA so far has interpreted the option to impose ''other corrective action'' (''OCA'') as requiring some further action in addition to complying with the steps prescribed in an approved NWRP for meeting quarterly net worth targets. Some further action would seem appropriate when a credit union either is not complying with its approved NWRP, or is implementing the prescribed action steps but still failing to achieve its quarterly net worth targets. But when a credit union has been both implementing the steps in its NWRP and timely achieving its net worth targets, demanding further action is superfluous, if not punitive. NCUA has found it difficult to fashion OCA that is more than a makeweight in these circumstances.

Congress left it entirely to the NCUA Board to ''take such other action'' in lieu of conservatorship and liquidation ''as the Board determines would better achieve the purpose of [PCA], after documenting why the action would better achieve that purpose.'' 12 U.S.C. 1790d(i)(1)(b). *See also* S. Rep. No. 193, 105th Cong., 2d Sess. 15 (1998). The NCUA Board has determined that the purpose of PCA—building net worth to minimize share insurance losses—is not undermined by declining to impose OCA when it is documented that a credit union already is achieving the purpose of PCA by complying with an approved NWRP and achieving its prescribed net worth targets. In other words, there would be no reason to demand more than complete success from a credit union that, so far, is completely successful in building net worth.

To implement a more flexible approach to imposing OCA in lieu of conservatorship and liquidation, the proposed rule revised subsection (c)(1)(iii) to provide that ''[OCA] may consist, in whole or in part, of complying with the timetable of quarterly steps and meeting quarterly net worth targets prescribed in an approved [NWRP].'' § 702.204 (c)(1)(iii). This would permit, but not require, NCUA to limit OCA to directing a credit union that already is in compliance with its approved NWRP to simply continue to comply, without undertaking any further action beyond what the NWRP already requires. NCUA received two comments; both supported this shift in approach to implementing OCA. Accordingly, the final rule adopts revised subsection (c)(1)(iii) as proposed.

b. *10-day appeal period.* The NCUA Board's authority to decide whether to

conserve a ''critically undercapitalized'' credit union, liquidate it, or allow OCA may be delegated only in the case of credit unions having assets of less than $5 million. 12 U.S.C. 1790d(i)(4); § 702.204(c)(4). In such cases, the credit union has a statutory ''right of direct appeal to the NCUA Board of any decision made by delegated authority.'' *Id.* However, neither the Act nor part 741 sets a deadline by which a credit union must appeal a delegated decision to the NCUA Board. The lack of a deadline for exercising the right to appeal delegated decisions to the NCUA Board gives ''critically undercapitalized'' credit unions at least the appearance of an unlimited opportunity to challenge a Regional Director's decision.

To impose similar finality upon the unfolding timetable of decisions that starts when a credit union becomes ''critically undercapitalized,'' the proposed rule revised subsection (c)(4) to set a deadline of ten calendar days in which to appeal a delegated decision. Objecting that 10 days is too few for small credit unions with unsophisticated management, the one commenter who addressed this section advocated a 30-day appeal period instead. However, the final rule adopts the proposed 10-day appeal period for two reasons. First, it parallels the 10-day window that the Act provides for seeking judicial review of any statutory conservatorship or liquidation. 12 U.S.C. 1786(h)(3), 1787(a)(1)(B). Second, a longer appeal period would unreasonably delay the payout of shares to members that must promptly follow a liquidation.

c. *Insolvent FCU.* The NCUA Board generally must liquidate a credit union eventually if it remains ''critically undercapitalized.'' § 702.204(c). Independently of PCA, however, the Act directs that ''[u]pon its finding that a Federal credit union * * * is insolvent, the Board shall close such credit union for liquidation.'' 12 U.S.C. 1787(a)(1)(A). Therefore, in the case of a ''critically undercapitalized'' *federal* credit union that is insolvent (*i.e.*, has a net worth ratio of less than zero), NCUA has the option of an insolvency-based liquidation. To clarify that this option is available, new subsection (d) to § 702.204 provides that ''a 'critically undercapitalized' federal credit union that has a net worth ratio of less than zero percent (0%) may be placed into liquidation on grounds of insolvency pursuant to [§ 1787(a)(1)(A)].''

8. Section 702.205—Consultation With State Officials on Proposed PCA

As explained above in reference to new subsection (c) of § 702.201, a cross-reference in § 702.205(c) misidentified the decision whether to permit a decrease in a FISCU's quarterly earnings retention as a DSA. To correct this error, the final rule deletes the erroneous cross-reference and relocates the ''consult and seek to work cooperatively'' requirement in § 702.201(c).

9. Section 702.206—Net Worth Restoration Plans

a. *Contents of NWRP.* Section 702.206 prescribes the contents of an NWRP that must be submitted for approval by credit unions classified ''undercapitalized'' or lower.[6] Among the items an NWRP must address is how the credit union will comply with MSAs and DSAs. § 702.206(c)(1)(iii). Some credit unions that were *not* subject to a DSA interpreted that requirement as a demand either to consent to a DSA, or to explain prospectively how the credit union *would* comply with DSAs if the NCUA Board were to impose any. The proposed rule revised subsection (c)(1)(iii) to clarify that an NWRP need only address whatever DSAs, if any, the NCUA Board *already* has imposed on the credit union. The one commenter who addressed this revision supported it. The final rule adopts revised subsection (c)(1)(iii) as proposed.

b. *Publication of NWRP.* Publication of an NWRP is not a prerequisite to enforcing its provisions as authorized in 12 CFR 747.2005, but this fact is not expressly stated in § 702.206 itself. The omission has led some to assume that an NWRP, like a ''Letter of Understanding and Agreement,'' must be published in order to subsequently be enforceable. The Act mandates that a ''written agreement or other written statement'' must be published in order for a violation to be enforceable ''unless the Board, in its discretion, determines that publication would be contrary to the public interest.'' 12 U.S.C. 1786(s)(1)(A). To the extent an NWRP qualifies as a ''written agreement or other written statement'' under § 1786(s)(1)(A), the NCUA Board does not intend to publish NWRPs because it has determined that publication would expose the credit union to reputation risk that would be contrary to the public interest. Therefore, the proposed rule added new subsection (i) to § 702.206, clarifying that ''An NWRP need not be published to be enforceable because publication would be contrary to the public interest.'' NCUA received two comments on the clarification and both supported it. Therefore, the final rule adopts new subsection (i) as proposed.

c. *Alternative capital.* The proposed rule did not reference subsection (e), which permits consideration of any ''regulatory capital'' a credit union may have in evaluating an NWRP. Nonetheless, NCUA received three comments urging the adoption of some form of alternative capital not only to be considered in evaluating an NWRP, but also to offset an applicable RBNW requirement. A fourth commenter opposed alternative capital in any form. The final rule does not address these comments because this rulemaking was not intended by the NCUA Board to be a forum for exploring or introducing alternative forms of capital.

10. Section 702.303—PCA for ''Adequately Capitalized'' New Credit Unions

Under the original alternative system of PCA for new credit unions, a credit union that managed to become ''adequately capitalized'' while still new was subject to the same minimum earnings retention that applies to non-new credit unions that are ''adequately capitalized.'' [7] § 702.201(a). In contrast, ''new'' credit unions that stayed classified below ''adequately capitalized'' were not subject to minimum earnings retention; they had to increase net worth only ''by an amount reflected in the credit union's approved initial or revised business plan.'' § 702.304(a)(1). This created a disincentive for a ''new'' credit union to become ''adequately capitalized'' because the reward for keeping its net worth ratio below 6 percent is that it is relieved from complying with a minimum earnings retention amount.

To eliminate the disincentive, the proposed rule put all new credit unions having a net worth lower than 7 percent in parity for purposes of earnings retention. 67 FR at 38437. An ''adequately capitalized'' new credit union would no longer be subject to the same minimum earnings retention as a non-new counterpart. Instead, like new credit unions in lower categories, it would be required to increase net worth quarterly by ''an amount reflected in its

[6] As noted earlier in this preamble, the comments on the concept of ''safe harbor'' approval of an NWRP are addressed in a separate proposed rule found elsewhere in this volume of the **Federal Register.**

[7] The final rule corrects the wording of § 702.303, which inadvertently extended that section to ''new'' credit unions classified lower than ''adequately capitalized.'' Sections 702.304 and 702.305 continue to prescribe PCA for new credit unions in those net worth categories.

approved initial or revised business plan'' until it becomes ''well capitalized.'' In the absence of such a plan, however, the credit union would remain subject to the same quarterly minimum earnings retention as non-''new'' credit unions.

Two commenters supported parity among new credit unions for earnings retention purposes. Advocating a far less flexible approach, a third commenter (a banking industry trade association) objected that exempting any new credit unions from the statutory minimum earnings retention is not in accordance with CUMAA. That commenter overlooks the fact that CUMAA applies a minimum earnings retention requirement to non-new credit unions; it prescribed no earnings retention requirement at all for new credit unions. 12 U.S.C. 1790d(e)(1). Instead, CUMAA gave NCUA discretion in developing an alternative system of PCA, provided that it recognized that new credit unions initially have no net worth; need reasonable time to accumulate net worth; and need incentives to become ''adequately capitalized'' by the time they no longer qualify as ''new.'' 12 U.S.C. 1790d(b)(2)(B). *See* 64 FR 27090, 27098 (May 18, 1999) (justification for flexible approach). It is entirely consistent with this last statutory criterion to eliminate any disincentive—such as *minimum* earnings retention—for a new credit union to reach ''adequately capitalized'' while it is still ''new.''

11. *Section 702.304—PCA for ''Moderately Capitalized,'' ''Marginally Capitalized'' and ''Minimally Capitalized'' New Credit Unions*

As explained above, the final rule modifies § 702.201(a) to specify that earnings retention must increase the ''the dollar amount'' of net worth, not simply the net worth ratio itself. To conform to that modification, § 702.304(a)(1) is revised accordingly.

12. Section 702.305—PCA for ''Uncapitalized'' New Credit Unions

a. *Member business loan restriction.* Part 702 originally gave an ''uncapitalized'' new credit union full relief from all MSAs while it was operating within the period allowed by its initial business plan to have no net worth. § 702.305(a). An unintended consequence of this forbearance was that ''uncapitalized'' credit unions were free of the MSA restricting MBLs; that restriction applied only when a credit union managed to attain *some* net worth and rise to the ''minimally capitalized'' net worth category.[8] Yet a ''minimally capitalized'' credit union arguably is better suited to expand its MBL portfolio than one that remains ''uncapitalized.'' Further, making PCA *more* demanding as a credit union's net worth and category classification improve, rather than relaxing it, is contrary to the purpose of PCA. To rectify this unintended consequence, the proposed rule extended subsection (a) to include an ''uncapitalized'' new credit union that is operating with no net worth as permitted by an initial business plan. 67 FR at 38437. As a result, ''uncapitalized'' new credit unions are all subjected to the MBL restriction, § 702.305(a)(3), regardless whether they are operating with no net worth under an initial business plan, or have declined to ''uncapitalized'' after reaching a higher net worth category. NCUA received no comments on this section. Accordingly, the final rule adopts revised subsection (a) as proposed.

b. *Filing of revised business plan.* Subsection (a)(2) generally required an ''uncapitalized'' new credit union to submit a revised business plan (''RBP'') within 90 days following either of two events—expiration of the period that the credit union's initial business plan allows it to operate with no net worth, or the effective date that it declined to ''uncapitalized'' from a higher net worth category. This contrasts with the 30-day period that ''moderately capitalized,'' ''marginally capitalized'' and ''minimally capitalized'' credit unions are given to file an RBP. § 702.306(a)(1). Ninety days is an unduly long filing period given that an ''uncapitalized'' credit union faces mandatory conservatorship or liquidation if it fails to increase net worth to at least two percent. Furthermore, it is counterintuitive to give a credit union that *has* a net worth deficit three times as long to devise a plan for generating positive earnings than is given to credit unions that already have net worth.

The proposed rule put all new credit unions that must file an RBP in parity. First, it deleted the 90-day filing window for ''uncapitalized'' credit unions, thereby limiting them to the general 30-day window, once they are required to file an RBP. 67 FR at 38438. Second, it reorganized subsection (a)(2) to parallel the conditions that trigger other less than ''adequately capitalized'' new credit unions to revise their business plans, § 702.304(a)(2), even though only ''uncapitalized'' credit unions are initially allowed to operate with no net worth. To that end, the proposed rule required an ''uncapitalized'' credit union to submit an RBP if it either: fails to increase net worth (*i.e.*, reduce its earnings deficit) as its existing business plan provides; has no approved business plan; or has violated the MSA restricting MBLs.

The sole commenter on this topic supported the 30-day window for filing an RBP, while also urging NCUA to relieve the burden on new credit unions by providing assistance in preparing RBPs. *See* § 702.307(a) (assistance in preparing RBPs). For the reasons set forth above in this section, the revisions to subsection (a)(2) are adopted as proposed.

c. *Liquidation or conservatorship if ''uncapitalized'' after 120 days.* Subsection (c)(2) generally required the NCUA Board to conserve or liquidate an ''uncapitalized'' new credit union that remains ''uncapitalized'' 90 days after its RBP is approved. It was silent, however, regarding conservatorship or liquidation of a credit union whose RBP is rejected. To correct this oversight, the proposed rule mandated conservatorship or liquidation of an ''uncapitalized'' new credit union after a 120-day period regardless whether an RBP has been approved or rejected. 67 FR at 38438. This period combines the 30-day window for submitting an RBP, § 702.306(a)(1), and the original 90-day period allowed for the credit union to develop sufficient positive earnings to avoid conservatorship and liquidation. The 120-day period runs from the later of either the effective date of classification as ''uncapitalized'' or, if a credit union is operating with no net worth in the period prescribed by its initial business plan, the last day of the calendar month after expiration of that period. Because the period for operating with no net worth typically runs on a quarterly basis, the last day of the calendar month after it expires parallels the calendar month that separates the quarter-end and the effective date of classification as ''undercapitalized.''

NCUA received no comments on the revisions to subsection (c)(2) and, therefore, they are adopted as proposed. In addition, the final rule relocates to a new subsection (c)(3) the existing exception to mandatory conservatorship or liquidation for a credit union that is able to demonstrate that it is viable and has a reasonable prospect of becoming ''adequately capitalized.''

d. *''Uncapitalized'' new FCU.* As explained above in reference to new subsection (d) of § 702.204, there are two options for liquidating a federal

[8] The earnings retention requirement, § 702.305(a)(1), is ineffective against an ''uncapitalized'' credit union because a credit union that *has* an undivided earnings deficit has no net worth to retain.

credit union that has no net worth—a PCA-based liquidation, 12 U.S.C. 1787(a)(3)(A)(ii), or an insolvency-based liquidation. 12 U.S.C. 1787(a)(1)(A). Both are available when a new *federal* credit union either fails to timely submit an RBP, § 702.305(c)(1), or remains ''uncapitalized'' 120 days after the effective date of classification, § 702.305(c)(2). To clarify that this option is available, the final rule adds new subsection (d) to § 702.305, providing that ''an 'uncapitalized' federal credit union may be placed into liquidation on grounds of insolvency pursuant to [§ 1787(a)(1)(A)].''

13. Section 702.306—Revised Business Plans for New Credit Unions

a. *Filing schedule.* Subsection (a)(1) required ''moderately capitalized,'' ''marginally capitalized'' and ''minimally capitalized'' credit unions to file an RBP within 30 days after failing to meet a quarterly net worth target prescribed in an existing business plan. As discussed above, the final rule eliminates the 90-day filing window for ''uncapitalized'' credit unions. § 702.305(a)(2). To conform to that modification, the final rule also modifies subsection (a)(1) to apply the 30-day filing window uniformly to all new credit unions classified less than ''adequately capitalized'' or that have violated the MSA restricting MBLs. § § 702.304(a)(3), 702.305(a)(3).

The original rule's 30-day filing period ran from ''the effective date (per § 702.101(b)) of the credit union's failure to meet a quarterly net worth target prescribed in its then-present business plan.'' § 702.306(a)(1). Even as revised, however, § 702.101(b), which addresses the effective date of classification among the net worth categories, says nothing to determine when a quarterly net worth target is met. The subtlety of this distinction may confuse credit unions that have no then-present approved business plan or have violated the MSA restricting MBLs. Therefore, the proposed rule further revised subsection (a)(1) to effectively give new credit unions that fail to meet a quarterly target 60 days following the quarter-end to file an RBP. § 702.306(a)(1)(i). The 60-day period combines the calendar month that separates the quarter-end from the effective date of classification, with the uniform 30-day filing period that commences on the effective date. Finally, the proposed rule revised subsection (a)(1) still further to clarify that, for new credit unions that either have no approved business plan or that have violated the MBL restriction, the effective date of classification as less than ''adequately capitalized'' triggers the 30-day window for filing an RBP. § 702.306(a)(1)(ii)–(iii). NCUA received no comments on the revisions to the filing schedule for RBPs. Accordingly, revised subsection (a)(1) is adopted as proposed.

b. *Timetable of net worth targets.* Subsection (b)(2) prescribed the contents of an RBP, which must include a timetable of quarterly net worth targets extending for the term of the plan ''so that the credit union becomes 'adequately capitalized' and remains so for four consecutive quarters.'' It also warned that a ''complex'' new credit union that is subject to an RBNW requirement may need to attain a net worth ratio higher than 6 percent to become ''adequately capitalized.'' The proposed rule rectified two flaws in this section. First, in contrast to an NWRP, the objective of an RBP is to build net worth so that a new credit union becomes ''adequately capitalized'' by the time it no longer is ''new,'' [9] rather than by the end of the term of the plan. 65 FR at 8578; 64 FR 27090, 27099 (May 18, 1999) (chart). The proposed rule revised subsection (b)(2) so that an RBP's net worth targets ensure the new credit union will become ''adequately capitalized'' by the time it no longer qualifies as ''new.'' 67 FR at 38438. Second, under part 702 new credit unions cannot be ''complex'' or subject to an RBNW requirement because, by definition, they do not meet the $10 million asset minimum. § 702.103(a)(1). Therefore, the proposed rule deleted the warning to new credit unions that are ''complex.'' NCUA received no comments on either of these revisions. Accordingly, revised subsection (b)(2) is adopted as proposed.

c. *Publication of RBP.* As explained above, the final rule adds a new subsection (i) to § 702.206, to clarify that publication of an NWRP is not a prerequisite to enforcing its provisions as authorized in 12 CFR 747.2005. The same is true of an RBP, but this fact was similarly omitted from § 702.306. To the extent an RBP qualifies as a ''written agreement or other written statement'' under 12 U.S.C. 1786(s)(1)(A), the NCUA Board does not intend to publish RBPs because it has determined that publication would expose the credit union to reputation risk that would be contrary to the public interest. Therefore, the final rule adds new subsection (h) to § 702.306, clarifying that ''An RBP need not be published to be enforceable because publication would be contrary to the public interest.''

13. Section 702.401—Charges to Regular Reserve

a. *Regular reserve.* Although the proposed rule did not reference subsection (b), which requires credit unions ''to establish and maintain a regular reserve account,'' four commenters criticized it as obsolete. The NCUA Board prefers to retain the regular reserve at this time primarily for two reasons. First, it facilitates the statutory earnings retention requirement, 12 U.S.C. 1790d(e), by holding the earnings that credit unions classified ''adequately capitalized'' or lower are required to ''set aside.'' § 702.201. And second, it continues to function as an early warning signal of safety and soundness problems because, as explained below, regulatory review and approval is required before a credit union can take certain actions—charging losses to, and paying dividends from, the regular reserve—that would cause its net worth to decline below 6 percent.

b. *Minimum net worth to charge losses without approval.* Subsection (c)(1) originally allowed the board of directors of a federally-insured credit union that had depleted the balance of its undivided earnings and other reserves to charge losses to the regular reserve account without regulatory approval so long as the charge did not reduce the credit union's net worth classification below ''well capitalized'' (*i.e.*, net worth ratio of 7 percent or greater). § 702.401(c)(1). That net worth category was established as the minimum for charging losses without regulatory approval because the categories below ''well capitalized'' trigger MSAs. However, the proposed rule lowered the minimum category to ''adequately capitalized'' (*i.e.*, 6 percent net worth ratio) in order to give credit unions the flexibility to decide for themselves whether charging losses is worth triggering the single MSA that applies to that category—the quarterly earnings retention. § 702.201(a); 67 FR at 38439. In addition, the proposed rule expressly reminded credit unions that they must deplete their undivided earnings balance before making any charge to the regular reserve. All seven of the commenters who addressed these proposed revisions supported them. Thus, revised subsection (c)(1) is adopted as proposed.

c. *Dual approval to charge losses.* Subsection (c)(2) originally required the prior approval of the ''appropriate State official,'' but not the approval of the ''appropriate Regional Director,'' when a

[9] A credit union remains ''new'' as long as it is in operation less than 10 years and has assets of $10 million or less. 12 U.S.C. 1790d(o)(4); § 702.301(b).

State-chartered credit union seeks to charge losses that would cause it to decline below the minimum category. Omitting the approval of NCUA Regional Directors was inconsistent with the protocol applied elsewhere in part 702 requiring joint State and Federal approval of PCA decisions affecting State-chartered credit unions. *E.g.,* § § 702.206(a)(1), 702.306(a)(1). To correct this inconsistency, the proposed rule modified § 702.401(c)(2) to require the concurrence of both the ''appropriate State official'' *and* ''the appropriate Regional Director'' to permit a State-chartered credit union to charge losses to the regular reserve. In addition, the proposed rule clarified that written approval may consist of an approved NWRP that allows such charges.

The sole commenter on the revisions proposed for subsection (c)(2) objected that the dual approval requirement would unnecessarily overburden NCUA with the oversight of State officials. On the contrary, the NCUA Board does not consider its approval to be a function of overseeing State officials. Rather, its approval for a State-chartered credit union to charge losses to the regular reserve is integral to PCA because of NCUA's independent role as insurer of the shares and deposits of federally-insured State-chartered credit unions. Accordingly, revised subsection (c)(2) is adopted as proposed.

15. Section 702.403—Payment of Dividends

a. *Minimum net worth to pay dividends without approval.* Subsection (b)(1) originally allowed the board of directors of a federally-insured credit union that had depleted the balance of undivided earnings to pay dividends out of the regular reserve account without regulatory approval so long as it did not cause the credit union to decline below ''well capitalized.'' § 702.403(b)(1). As explained above in regard to § 702.401(c)(1), the proposed rule similarly lowered to ''adequately capitalized'' the minimum net worth category in which credit unions may pay dividends out of the regular reserve without regulatory approval. This would give credit unions that have depleted undivided earnings the flexibility to decide for themselves whether drawing down the regular reserve to pay dividends is worth triggering the quarterly earnings retention requirement that applies to ''adequately capitalized'' credit unions. § 702.201(a).

b. *Dual approval to pay dividends.* As with § 702.401(c)(2) discussed above, subsection (b)(2) originally required the prior approval of the ''appropriate State official,'' but not the approval of the ''appropriate Regional Director,'' when paying dividends out of the regular reserve would cause a State-chartered credit union to decline below the minimum net worth category. In addition, omitting Regional Director approval may suggest, incorrectly, that a State official's approval to pay dividends from the regular reserve under § 702.401(b) makes it unnecessary to independently obtain both the State official's and the Regional Director's approval under § 702.201(b) for a State-chartered credit union to decrease its earnings retention in order to pay dividends. For this reason and the reason explained in the preceding section, the proposed rule corrected this omission by revising subsection (b)(2) to require the concurrence of both the ''appropriate State official'' *and* ''the appropriate Regional Director'' for a State-chartered credit union to pay dividends out of its regular reserve. In addition, the proposed rule clarified that written approval may consist of an approved NWRP that allows such dividend payments. The two commenters who addressed the revisions proposed for subsections (b)(1) and (b)(2) supported them. Accordingly, they are adopted as proposed.

Subpart A of Part 741—Requirements for Insurance

16. Section 741.3—Adequacy of Reserves

Subsection (a)(2) originally allowed State-chartered credit unions to charge losses other than loan losses to the regular reserve in accordance with State law or procedures, but without regulatory approval, provided that the charges did not cause the credit union to decline below ''well capitalized.'' 12 CFR 741.3(a)(2). The preceding subsection (a)(1) incorporates by reference all of part 702 as a prerequisite for insurability of State-chartered credit unions. As discussed above, § 702.401(c) already imposes on State-chartered credit unions the same conditions for regulatory approval that subsection (a)(2) prescribes for an insured credit union seeking to charge losses to the regular reserve. Because this makes subsection (a)(2) redundant, the final rule eliminates it from § 741.3.

The final rule's removal of subsection (a)(2) does not mean that § 702.401(c) preempts ''either state law or procedures established by the appropriate State official'' that restrict a State-chartered credit union's ability to charge losses to the regular reserve. On the contrary, such charges would independently remain subject to applicable State laws and procedures. Further, an appropriate State official would retain complete discretion to withhold approval of such charges, under § 702.401(c)(2), on grounds that they would violate State law or procedures.

Subpart L of Part 747—Issuance, Review and Enforcement of Orders Imposing PCA

17. Section 747.2005—Enforcement of Orders

The NCUA Board is authorized to ''assess a civil money penalty against a credit union which fails to implement a net worth restoration plan * * * or a revised business plan under * * * part 702.'' 12 CFR 747.2005(b)(2). As explained above, the NCUA Board has determined that it is not in the public interest to require publication of an NWRP or an RBP in order for either to be enforceable and § § 702.206 and 702.306 are modified accordingly. The final rule makes a conforming modification to § 747.2005(b)(2) to provide that a civil money penalty may be assessed for failure to implement a plan ''regardless whether the plan was published.''

Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis describing any significant economic impact a proposed regulation may have on a substantial number of small credit unions (primarily those under $1 million in assets). The proposed rule improves and simplifies the existing system of PCA mandated by Congress. 12 U.S.C. 1790d. The NCUA Board has determined and certifies that the final rule will not have a significant economic impact on a substantial number of small credit unions and, therefore, a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

The reporting requirements in this final rule have been submitted to the Office of Management and Budget. Under the Paperwork Reduction Act of 1995, no person is required to respond to a collection of information unless it displays a valid OMB number. Control number 3133–0161 has been issued for part 702 and will be displayed in the table at 12 CFR part 795.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on State and local interests.

NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily adheres to the fundamental federalism principles addressed by the executive order. This final rule will apply to all federally-insured credit unions, including State-chartered credit unions. Accordingly, it may have a direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. This impact is an unavoidable consequence of carrying out the statutory mandate to adopt a system of prompt corrective action to apply to all federally-insured credit unions. NCUA staff has consulted with a committee of representative State regulators regarding the impact of the proposed revisions on State-chartered credit unions. Their comments and suggestions are reflected in the proposed rule.

Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (Pub. L. 104–121) provides generally for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by section 551 of the Administrative Procedure Act, 5 U.S.C. 551. The Office of Management and Budget has determined that this rule is not a major rule.

List of Subjects

12 CFR Parts 702 and 741

Credit unions, Reporting and recordkeeping requirements.

12 CFR Part 747

Administrative practices and procedures, Credit unions.

By the National Credit Union Administration Board on November 21, 2002.

Becky Baker,

Secretary of the Board.

Subject Index

E

F

I

L

M

T

U

V